



**SECURITIES AND EXCHANGE COMMISSION**  
**[Release No. 34- 93914; File No. SR-FINRA-2021-008]**

**Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to Security-Based Swaps**

January 6, 2022

**I. Introduction**

On April 26, 2021, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend FINRA Rules 0180, 4120, 4210, 4220, 4240 and 9610 to clarify the application of its rules to security-based swaps (“SBS”) following the Commission’s completion of its rulemaking regarding SBS dealers (“SBSDs”) and major SBS participants (“MSBSPs”) (collectively, “SBS Entities”).

The proposed rule change was published for comment in the Federal Register on May 12, 2021.<sup>3</sup> On June 14, 2021, FINRA consented to an extension of the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to August 10, 2021.<sup>4</sup> The Commission received two comments on the proposed rule change during

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Exchange Act Release No. 91789 (May 12, 2021), 86 FR 26084 (May 12, 2021) (File No. SR-FINRA-2021-008) (“Notice”).

<sup>4</sup> Letter from Robert McNamee, Assistant General Counsel, Office of General Counsel, FINRA to Daniel Fisher, Division of Trading and Markets, Commission dated June 14, 2021.

the initial comment period.<sup>5</sup> On August 9, 2021, FINRA responded to the comment letters received in response to the Notice and filed an amendment to the proposed rule change (“Amendment No. 1”).<sup>6</sup> On August 9, 2021, the Commission issued an Order Instituting Proceedings (“OIP”) to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No.1.<sup>7</sup> The Commission received an additional four comments in response to the OIP.<sup>8</sup> On September 30, 2021, the FINRA consented to an extension of the time period in which the Commission must approve or disapprove the proposed rule change to January 7, 2022.<sup>9</sup> This order approves the proposed rule change, as modified by Amendment No. 1.

## II. Description of the Proposed Rule Change

### A. Background

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Title

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<sup>5</sup> Letter from Kyle L. Brandon, Managing Director, Head of Derivatives Policy, Securities Industry and Financial Markets Association (“SIFMA”) to Vanessa A. Countryman, Secretary, Commission, dated June 2, 2021 (“SIFMA Letter”) and Matthew R. Cohen, Chief Executive Officer and Richard C. Chase, Chief Compliance Officer, Provable Markets LLC to Jill M. Peterson, Assistant Secretary, Commission, dated June 7, 2021 (“PML Letter”). Letters are available at the Commission’s website at <https://www.sec.gov/comments/sr-finra-2021-008/srfinra2021008.htm>.

<sup>6</sup> See letter from Robert McNamee, Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated Aug. 9, 2021 (“FINRA Letter”). The FINRA Letter is available at the Commission’s website at <https://www.sec.gov/comments/sr-finra-2021-008/srfinra2021008-9125111-247215.pdf>. Amendment No. 1 is available at [https://www.finra.org/sites/default/files/2021-08/SR-FINRA-2021-008-Amendment\\_1.pdf](https://www.finra.org/sites/default/files/2021-08/SR-FINRA-2021-008-Amendment_1.pdf).

<sup>7</sup> See Exchange Act Release No. 92617 (Aug. 9, 2021), 86 FR 44761 (Aug. 13, 2021) (File No. SR-FINRA-2020-008) (“OIP”).

<sup>8</sup> See Letters from Anonymous dated Aug. 10, 2021; Blake Daniels dated Aug. 10, 2021, Tristan Kifer dated Aug. 10, 2021; and Eileen Loh dated Aug. 10, 2021 (“Letters”). Letters are available at the Commission’s website at <https://www.sec.gov/comments/sr-finra-2021-008/srfinra2021008.htm>.

<sup>9</sup> Letter from Robert McNamee, Assistant General Counsel, Office of General Counsel, FINRA to Daniel Fisher, Division of Trading and Markets, Commission dated September 30, 2021.

VII” or “Dodd-Frank Act”)<sup>10</sup> established a comprehensive new regulatory framework for over-the-counter (“OTC”) derivatives, commonly known in the industry as “swaps.” It divided regulatory jurisdiction over swap products between the Commodity Futures Trading Commission (“CFTC”) and the Commission, with the CFTC regulating “swaps” and the SEC regulating SBS, and the SEC and the CFTC regulating mixed swaps.<sup>11</sup> The Dodd-Frank Act directed the SEC to promulgate rulemakings implementing the new regulatory framework for SBS, including rules requiring SBS Entities to register with the Commission and to be subject to requirements related to business conduct and supervision, documentation standards; recordkeeping and financial reporting; and capital, and margin and segregation. The Dodd-Frank Act also directed the Commission to promulgate rules applicable to all market participants including requiring regulatory reporting and public dissemination of SBS transaction information; and those creating processes to require SBS to become subject to mandatory clearing and execution on a registered or exempt execution facility or exchange.<sup>12</sup> The Commission has now finalized a majority of these rulemakings.<sup>13</sup> As of October 6, 2021, SBS Entities are permitted to register with the

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<sup>10</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>11</sup> The terms “swap” and “security-based swap” are defined in Sections 721 and 761 of the Dodd-Frank Act. The Commission and the CFTC have jointly promulgated rules further defining these terms. See Exchange Act Release No. 67453 (Jul. 18, 2012), 77 FR 48208 (Aug. 13, 2012) (Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping) (“Product Definitions”). Very generally, SBS are swaps referencing a single security or loan, or a narrow-based security index. Certain products sharing characteristics of both swaps and SBS are regulated as “mixed swaps” subject to both CFTC and SEC jurisdiction.

<sup>12</sup> See Dodd-Frank Act Section 763.

<sup>13</sup> See Exchange Act Release No. 74244 (Feb. 11, 2015), 80 FR 14564 (Mar. 19, 2015) (Final Rule: Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information) (“Regulation SBSR Release”); Exchange Act Release No. 75611 (Aug. 5, 2015), 80 FR 48964 (Aug. 14, 2015) (Final Rule: Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants) (“Registration Process

Commission and are required to comply with the Title VII rulemakings.<sup>14</sup> The deadline for the initial wave of SBS Entity registrations was November 1, 2021.

Title VII also amended the definition of “security” under the Exchange Act to expressly encompass SBS.<sup>15</sup> Therefore, in addition to the comprehensive new SBS-specific regulatory framework discussed above, SBS are now also defined as securities under the Exchange Act and the rules thereunder. As a result, according to FINRA, any FINRA rule applicable to FINRA members’ activities involving a security, securities business, a transaction involving a security or a securities position would apply to those activities involving SBS.<sup>16</sup> Consistent with the SEC’s actions in this area, on July 8, 2011, FINRA filed for immediate effectiveness FINRA Rule 0180,

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Release”); Exchange Act Release No. 77617 (Apr. 14, 2016), 81 FR 29960 (May 13, 2016) (Final Rule: Business Conduct Standards for Security- Based Swap Dealers and Major Security-Based Swap Participants) (“Business Conduct Standards Release”); Exchange Act Release No. 78011 (Jun. 8, 2016), 81 FR 39808 (Jun. 17, 2016) (Final Rule: Trade Acknowledgment and Verification of Security-Based Swap Transactions) (“Trade Acknowledgment and Verification Release”); Exchange Act Release No. 86175 (Jun. 21, 2019), 84 FR 43872 (Aug. 22, 2019) (Final Rule: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security- Based Swap Participants and Capital and Segregation Requirements for Broker- Dealers) (“Capital, Margin, and Segregation Release”); Exchange Act Release No. 87005 (Sep. 19, 2019), 84 FR 68550 (Dec. 16, 2019) (Final Rule: Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers) (“Recordkeeping Release”); Exchange Act Release No. 87780 (Dec. 18, 2019), 85 FR 6270 (Feb. 4, 2020) (Final Rules; Guidance: Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements) (“Cross-Border Release”); Exchange Act Release No. 87782 (Dec.18, 2019), 85 FR 6359 (Feb. 4, 2020) (Final Rule: Risk Mitigation Techniques for Uncleared Security-Based Swaps) (“Risk Mitigation Release”).

<sup>14</sup> See Notice at 26085.

<sup>15</sup> See Dodd-Frank Act Section 761(a)(2) (inserting “security-based swap” in the definition of “security” in Section 3(a)(10) of the Exchange Act); see also 15 U.S.C. 78c(a)(10).

<sup>16</sup> See Notice at 26085.

which, with certain exceptions noted below, temporarily limits the application of FINRA rules with respect to SBS.<sup>17</sup> This rule is currently set to expire on February 6, 2022.<sup>18</sup>

Current FINRA Rule 0180 broadly excepts SBS activities from most FINRA rules. Specifically, FINRA Rule 0180(a) provides that FINRA rules shall not apply to members' activities and positions with respect to SBS, except for: (i) FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); (ii) FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices); (iii) FINRA Rule 3310 (Anti-Money Laundering Compliance Program); and (iv) FINRA Rule 4240 (Margin Requirements for Credit Default Swaps).<sup>19</sup> In addition, FINRA Rule 0180(b) provides that the following rules apply to members' activities and positions with respect to SBS only to the extent they would have applied as of July 15, 2011 (i.e., the day before the effective date of Title VII): (i) NASD Rule 3110 (Supervision) and all successor FINRA Rules to such NASD Rule; (ii) the FINRA Rule 4500 Series (Books, Records, and Reports); and (iii) the FINRA Rule 4100 Series (Financial Condition). Finally, FINRA Rule 0180(c) provides that certain other rules apply as necessary to effectuate members' compliance with paragraphs (a) and (c) of the rule.

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<sup>17</sup> See Exchange Act Release No. 64884 (Jul. 14, 2011), 76 FR 42755 (Jul. 19, 2011) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2011-033). To allow sufficient time to consider the complex interpretative issues resulting from defining SBS as securities, the Commission also issued a number of temporary exemptive orders relating to the regulation of SBS as securities, all of which have either expired or been made permanent now that the October 6, 2021, registration compliance date for the Commission's SBS regulatory framework has passed. See Exchange Act Release No. 92837 (Sep. 1, 2021), 86 FR 50391 (Sep. 8, 2021) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2021-021) ("Extension Notice").

<sup>18</sup> FINRA has extended the expiration date of FINRA Rule 0180 a number of times, most recently in September 2021. See, e.g., Extension Notice, supra note 17.

<sup>19</sup> FINRA Rule 4240 establishes an interim pilot program with respect to margin requirements for any transactions in credit default swaps ("CDS") held in an account at a FINRA member. The interim pilot program under FINRA Rule 4240 will expire on April 6, 2022. See id.; see also FINRA Rule 4240(a). FINRA Rule 4240 Supplementary Material .02 clarifies that the rule does not apply to a member that is registered with the Commission as an SBSB. See id.

In light of the Commission's October 6, 2021, registration compliance date, FINRA proposed in April 2021 to amend FINRA Rules 0180, 4120, 4210, 4220, 4240 and 9610 to clarify the application of FINRA rules to members' SBS activities after the Commission's registration compliance date. These proposed amendments would: (1) adopt a permanent FINRA Rule 0180 to replace the temporary rule set to expire on February 6, 2022; (2) amend FINRA's financial responsibility and operational rules to conform to the SEC's amendments to its capital, margin and segregation requirements for SBSDs and broker-dealers, and to otherwise take into account members' SBS activities; (3) adopt a new margin rule specifically applicable to SBS, replacing the expiring interim pilot program establishing margin requirements for CDS; and (4) amend Rule 9610 to permit FINRA to exempt members from Rule 0180 under the process set forth in FINRA's Rule 9600 series (Procedures for Exemptions).

**B. Proposed Rule 0180 (Application of FINRA Rules to Security-Based Swaps)**

Proposed Rule 0180(a) would provide that FINRA rules generally apply to members' SBS activities unless otherwise specifically excepted. This would reverse the presumption of the applicability of FINRA rules to members' SBS activities in the current, expiring temporary Rule 0180, which generally does not apply FINRA rules unless otherwise specified.

Proposed Rule 0180 paragraphs (b) through (g) would then specify the exceptions from the general presumption of applicability of FINRA rules in proposed Rule 0180(a). These proposed exceptions fall into three general categories: (1) general exceptions based on impracticability or operational burdens; (2) exceptions for SBS Entities already registered with the Commission and associated persons of SBS Entities; and (3) exceptions in connection with the conditions to the SEC's cross-border SBS counting exception. Proposed FINRA Rule 0180(i) would further authorize FINRA to exempt a person from the application of specific FINRA rules to SBS on a case-by-case basis, pursuant to the existing procedural framework set forth in the FINRA Rule 9600 series and as FINRA deems appropriate consistent with the protection of investors and the public interest.

### **C. Proposed Rule 0180(b) (General Exceptions from Applicability of FINRA Rules)**

Proposed Rule 0180(b) would provide that the following FINRA rules shall not apply to members' activities and positions with respect to SBS: (1) the Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities); (2) the Rule 7000 Series (Clearing, Transaction, and Order Data Requirements, and Facility Charges); and (3) the Rule 11000 Series (the Uniform Practice Code or "UPC"). The Rule 6000 and 7000 Series include rules relating to trading, quoting, clearing, and reporting for securities other than SBS (e.g., NMS stocks and over-the-counter equity securities), and therefore are not applicable to members' SBS activities.

According to FINRA, the UPC, contained in the Rule 11000 Series, is a series of rules, interpretations and explanations designed to make uniform, where practicable, custom, practice, usage, and trading technique in the investment banking and securities business, particularly with regard to operational and settlement issues.<sup>20</sup> The Rule 11000 Series contains, for example, rules addressing matters relating to the delivery of securities, certificated security matters, delivery of bonds, and close-out procedures.<sup>21</sup> According to FINRA, the UPC was created to simplify and facilitate cash securities transactions.<sup>22</sup>

By its terms, the UPC applies to all OTC secondary market transactions in securities between members, with enumerated exceptions.<sup>23</sup> FINRA believes that, as a result, the UPC could be interpreted as applying to SBS transactions in a limited set of circumstances—e.g., an

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<sup>20</sup> See Notice at 26088.

<sup>21</sup> Id.

<sup>22</sup> See id.

<sup>23</sup> See FINRA Rule 11100(a). Under FINRA Rule 11100(a)(1), transactions in securities between members which are compared, cleared or settled through the facilities of a registered clearing agency are not subject to the UPC, except to the extent that the rules of the clearing agency provide that rules of other organizations shall apply. Paragraphs (a)(2) through (a)(5) of FINRA Rule 11100 also provide exceptions for specific types of securities, including exempted securities, municipal securities, redeemable securities issued by investment companies and Direct Participation Program Securities.

SBS transaction between two FINRA members.<sup>24</sup> FINRA further believes that because the UPC could only be invoked for a small portion of the SBS market—particularly given that FINRA expects only a small number of its members to register as SBSDs or otherwise engage in SBS activities—applying the UPC to members’ SBS activities has the potential to create confusion and uncertainty in the SBS market.<sup>25</sup> Because SBS transactions involve bilateral contractual negotiations, often utilizing industry-standard SBS documentation, FINRA believes that the operational and settlement risks of SBS transactions are more appropriately addressed through other means, including standardized contractual provisions in that industry documentation, as well as, where applicable, the Commission’s risk mitigation requirements.<sup>26</sup>

**D. Proposed Rule 0180(c) and (d) (Exceptions for Registered SBS Entities and Associated Persons)**

As discussed above, the Title VII rulemakings completed by the Commission, including business conduct standards, trade acknowledgement and verification requirements, risk mitigation techniques for uncleared SBS, and recordkeeping rules for SBS Entities, are now in effect for SBS Entities, which are now required to be registered with the Commission unless their dealing activity is below the de minimis registration threshold.<sup>27</sup> As described below, certain of these new SBS-specific Commission rules are analogous to existing, generally applicable FINRA rules. Where the Commission has promulgated analogous rules applicable to registered SBS Entities, FINRA has proposed to provide exceptions from its rules for SBS

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<sup>24</sup> See Notice at 26088.

<sup>25</sup> Id.

<sup>26</sup> Id. at 26089.

<sup>27</sup> See Business Conduct Standards Release; Trade Acknowledgment and Verification Release; Risk Mitigation Release; Recordkeeping Release, supra note 13.



Entities registered with the Commission and, in certain circumstances, associated persons of those SBS Entities.<sup>28</sup>

Proposed Rules 0180(c) and (d) would provide exceptions to specified FINRA rules for FINRA members that are also registered as SBS Entities with the Commission or the associated person of the member, where two conditions are satisfied: (1) the SBS Entity or associated person is acting in the capacity of an SBS Entity or associated person of that SBS Entity; and (2) the activities or positions relate to the business of the SBS Entity within the meaning of Exchange Act Rule 15Fh-3(h)(1) (addressing supervisory obligations of SBS Entities).<sup>29</sup> The proposed exceptions are for FINRA rules that FINRA believes are analogous to SEC business conduct requirements<sup>30</sup>, and are limited to the members' SBS business and conditioned upon the application of the SEC's supervision rule for SBS Entities.<sup>31</sup>

Under proposed FINRA Rules 0180(c) and (d), these proposed exceptions would be available for eight FINRA rules that FINRA believes are analogous to SEC rules, subject to the conditions described above. Specifically, proposed FINRA Rule 0180(c) would provide exceptions for the following five FINRA rules, for registered SBS Entities and their associated persons:<sup>32</sup>

- FINRA Rule 2210(d) (Communications with the Public – Content Standards). Among other things, FINRA Rule 2210(d) requires that member communications be based on principles of fair dealing and good faith, be fair and balanced, and not omit any material

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<sup>28</sup> Id. at 26089.

<sup>29</sup> See 17 CFR 240.15Fh-3(h)(1). The exceptions in Rule 0180(c) would apply to both SBSs and MSBs or their associated persons, while the exceptions in Rule 0180(d) would apply only to SBSs or their associated persons (and not MSBs or their associated persons).

<sup>30</sup> See Notice at 26089.

<sup>31</sup> 17 CFR 240.15Fh-3(h)(1).

<sup>32</sup> See Notice at 26089.

facts or make false or exaggerated claims. FINRA believes that this rule is analogous to Exchange Act Rule 15Fh-3(g), which requires SBS Entities to, among other things, communicate with counterparties in a fair and balanced manner.<sup>33</sup>

- FINRA Rule 2232 (Customer Confirmations) generally requires members to provide customers with written confirmations in conformity with Exchange Act Rule 10b-10,<sup>34</sup> along with specified additional disclosures for certain types of securities. FINRA believes this is analogous to Exchange Act Rule 15Fi-2, which requires SBS Entities to provide trade acknowledgements and to establish, maintain and enforce written policies and procedures reasonably designed to obtain prompt verification of the terms of such trade acknowledgments.<sup>35</sup>
- FINRA Rules 3110 (Supervision), 3120 (Supervisory Control System) and 3130 (Annual Certification of Compliance and Supervisory Processes) require, among other things, each member to establish and maintain a supervisory system; establish, maintain and enforce written supervisory procedures; designate principals to establish, maintain and enforce a system of supervisory control policies and procedures; designate a chief compliance officer; and submit annual certifications to FINRA related to the member's compliance policies and written supervisory procedures. FINRA believes this is analogous to the supervision rule for SBS Entities in Exchange Act Rule 15h-3(h), which requires, among other things, an SBS Entity to establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its associated persons; designation of at least one person with authority to carry out supervisory

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<sup>33</sup> See Notice at 26089-90; see also 17 CFR 240.15Fh-3(g); Business Conduct Standards Release at 30000-02.

<sup>34</sup> See 17 CFR 240.10b-10; see also Notice at 26089-90.

<sup>35</sup> See 17 CFR 240.15Fi-2; see generally Trade Acknowledgment and Verification Release, supra note 13.

responsibilities; and establishment, maintenance and enforcement of written policies and procedures addressing supervision of the SBS Entity's SBS business.<sup>36</sup> Additionally, Exchange Act Rule 15Fk-1 requires each SBS Entity to designate a chief compliance officer and submit annual compliance reports to the SEC.<sup>37</sup>

In addition, proposed FINRA Rule 0180(d) would provide exceptions for the following three FINRA Rules for registered SBSDs and their associated persons, but not MSBSPs:<sup>38</sup>

- FINRA Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities) is FINRA's "pay-to-play" rule, which imposes restrictions on member firms engaging in distribution or solicitation activities with government entities. FINRA believes that Exchange Act Rule 15Fh-6 imposes analogous restrictions.<sup>39</sup>
- FINRA Rule 2090 (Know Your Customer) generally requires that each member use reasonable diligence to know and retain essential facts concerning every customer and the authority of each person acting on behalf of such customer. FINRA believes this rule is analogous to: Exchange Act Rule 15Fh-3(a), which generally requires SBS Entities to verify the status of their SBS counterparties, including verification that the counterparty is an eligible contract participant and whether the counterparty is a "special entity;"<sup>40</sup> and to Exchange Act Rule 15Fh-3(e), which requires each SBSD to establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record

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<sup>36</sup> See Notice at 26089-90.

<sup>37</sup> See 17 CFR 240.15Fk-1.

<sup>38</sup> See Notice at 26089.

<sup>39</sup> See *id.* at 26089-90; *see also* 17 CFR 240.15Fh-6; Business Conduct Standards Release at 30045-50.

<sup>40</sup> See Notice at 26089-90. "Special entity" is defined in Exchange Act Rule 15Fh-2(d) and includes certain government entities, employee benefit plans and endowments. See 17 CFR 240.15Fh-2(d).

of the essential facts concerning each counterparty whose identity is known to the SBSB that are necessary for conducting business with such counterparty.<sup>41</sup>

- FINRA Rule 2111 (Suitability) generally requires a member or associated person to have a reasonable basis that a recommended transaction or investment strategy is suitable for at least some investors as well as for the customer receiving the recommendation.

FINRA believes it is analogous to Exchange Act Rule 15Fh-3(f), which imposes suitability obligations on SBSBs with respect to recommendations of SBS or trading strategies involving SBS.<sup>42</sup> In addition, Exchange Act Rule 15Fh-5 applies special, enhanced requirements when SBS Entities act as counterparties to special entities.<sup>43</sup>

**E. Proposed Rule 0180(e) (Exceptions in Connection with Arranging, Negotiating, and Executing Activity)**

Proposed Rule 0180(e) would provide that the following FINRA rules shall not apply to members' activities and positions with respect to SBS, to the extent that the member or the associated person of the member, as applicable, is arranging, negotiating or executing SBS on behalf of a non-U.S. affiliate pursuant to, and in compliance with, the conditions of, Exchange Act Rule 3a71-3(d)(1):<sup>44</sup> (1) FINRA Rule 2111 (Suitability); (2) FINRA Rule 2210(d) (Communications with the Public – Content Standards); and (3) FINRA Rule 2232 (Customer Confirmations).<sup>45</sup> The availability of the exceptions under proposed FINRA Rule 0180(e) would

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<sup>41</sup> See Notice at 26089-90; see 17 CFR 240.15Fh-3(e).

<sup>42</sup> See Notice at 26090; see 17 CFR 240.15Fh-3(f).

<sup>43</sup> See Notice at 26091; see 17 CFR 240.15Fh-5.

<sup>44</sup> See 17 CFR 240.3a71-3(d)(1). Rule 3a71-3(d)(1) provides an exception from counting certain SBS transactions against the thresholds associated with the de minimis exception to the SBSB definition. See id.

<sup>45</sup> FINRA believes these proposed exceptions are appropriate for similar reasons as the proposed exceptions for SBS Entities in proposed FINRA Rules 0180(c) and (d). See Notice at 26093, n.64.

require the member's compliance with the conditions specified in Exchange Act Rule 3a71-3(d)(1)(ii)(B) as if the member were the counterparty to the SBS transactions (as opposed the non-U.S. affiliate).<sup>46</sup>

In connection with finalizing certain Title VII rulemakings, the SEC also adopted a number of rules and provided guidance to address the cross-border application of various SBS requirements. One of these rules, Exchange Act Rule 3a71-3(d), provides a conditional exception to the provisions of Exchange Act Rule 3a71-3 that otherwise would require non-U.S. persons to count—against the thresholds associated with the de minimis exception to the SBSD definition— SBS dealing transactions between non-U.S. counterparties when U.S. personnel arrange, negotiate or execute those transactions.<sup>47</sup> To qualify for this exception, all such arranging, negotiating or executing activity must, among other things, be conducted by U.S. personnel in their capacity as persons associated with a registered broker that meets certain capital requirements, or a registered SBSD, in each case so long as such entity is a majority-owned affiliate of the non-U.S. person relying on the exception (the “U.S. Registered Affiliate”).<sup>48</sup> The U.S. Registered Affiliate also must comply with certain rules applicable to SBSDs with respect to such SBS transactions as if the counterparties to the non-U.S. person relying on the exception also were counterparties to the U.S. Registered Affiliate and as if the U.S. Registered Affiliate were registered as an SBSD, if not so registered.<sup>49</sup>

Specifically, Exchange Act Rule 3a71-3(d)(1)(ii)(B) requires the U.S. Registered Affiliate to comply with, as a condition of the exception: (1) Section 15F(h)(3)(B)(i) and (ii) of

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<sup>46</sup> A member acting as the U.S. Registered Affiliate under Exchange Act Rule 3a71-3(d) would remain subject to all other FINRA rules applicable to such SBS brokerage activity. See supra note 44.

<sup>47</sup> See 17 CFR 240.3a71-3(d); Cross-Border Release at 6276-92.

<sup>48</sup> See 17 CFR 240.3a71-3(d)(1)(i).

<sup>49</sup> See 17 CFR 240.3a71-3(d)(1)(ii)(A).

the Exchange Act and Rule 15Fh-3(b) thereunder (disclosures of material risks and characteristics and material incentives or conflicts of interest), (2) Exchange Act Rule 15Fh-3(f)(1) (recommendations and suitability),<sup>50</sup> (3) Section 15F(h)(3)(C) of the Exchange Act and Rule 15Fh-3(g) thereunder (fair and balanced communications); and (4) Exchange Act Rule 15Fi-2 (acknowledgement and verification of SBS transactions) and the underlying definitions in Exchange Act Rule 15Fi-1.<sup>51</sup> FINRA believes it is appropriate to provide exceptions from the parallel FINRA rules to provide clarity and avoid unnecessary regulatory duplication, but only where the member is in fact complying with the rules specified in Exchange Act Rule 3a71-3(d)(1)(ii)(B).<sup>52</sup>

**F. Proposed Rule 0180(f) (Exceptions from Rules 2231, Customer Account Statements, and 4512, Customer Account Information)**

Proposed FINRA Rule 0180(f) would provide that FINRA Rules 2231 (Customer Account Statements) and 4512 (Customer Account Information) shall not apply to members' activities and positions with respect to SBS, to the extent that the member is acting in its capacity as an SBS Entity and the customer's account solely holds SBS and collateral posted as margin in connection with such SBS, provided that the member complies with the portfolio reconciliation requirements of Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account.

FINRA Rule 2231 generally requires each member to provide, on at least a quarterly basis, an

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<sup>50</sup> Rule 3a71-3(d)(1)(ii)(B)(2) does contain a limited exception from the requirement to comply with Exchange Act Rule 15Fh-3(f)(1). Specifically, if the U.S. Registered Entity reasonably determines that the counterparty to whom it recommends an SBS or trading strategy involving an SBS is an "institutional counterparty" as defined in Exchange Act Rule 15Fh-3(f)(4), the registered entity instead may fulfill its obligations under Rule 15Fh-3(f)(1)(ii) if it discloses to the counterparty that it is not undertaking to assess the suitability of the SBS or trading strategy involving an SBS for the counterparty.

<sup>51</sup> See 17 CFR 240.3a71-3(d)(1)(ii)(B).

<sup>52</sup> See Notice at 26093.

account statement to each customer containing a description of any securities positions, money balances or account activity during the period since the last customer account statement. FINRA Rule 4512 generally requires each member to maintain specified information for each customer account, including specified identifying information about the customer.

FINRA believes that the customer account statements required under FINRA Rule 2231 generally should reflect a holistic view of a member's relationship with its customer, including SBS transactions, positions and related collateral, if applicable.<sup>53</sup> Therefore, to the extent that a customer's account includes SBS along with other securities positions or activity, or related money balances, then FINRA believes that the account statement under FINRA Rule 2231 should include SBS.<sup>54</sup> However, FINRA understands that members that are also registered as SBS Entities may have customer accounts that hold solely SBS and related collateral, and do not hold any other securities positions or have any other securities activity.<sup>55</sup> While SBS Entities are not subject to a customer account statement requirement with respect to SBS, Exchange Act Rule 15Fi-3 includes requirements applicable to SBS Entities with respect to engaging in portfolio reconciliation with applicable counterparties on a periodic basis, which the Commission adopted as part of a broader set of risk mitigation requirements for SBS Entities.<sup>56</sup>

Exchange Act Rule 15Fi-3(a) generally requires SBS Entities to engage in portfolio reconciliation for all SBS with their SBS Entity counterparties, with the frequency of such

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<sup>53</sup> Id. at 26091.

<sup>54</sup> Id.

<sup>55</sup> Id.

<sup>56</sup> See 17 CFR 240.15Fi-3; Risk Mitigation Release at 6362-70. For purposes of Exchange Act Rule 15Fi-3, "portfolio reconciliation" is defined as "any process by which counterparties to one or more SBS" (1) exchange the material terms of all SBS in the SBS portfolio between the counterparties, (2) exchange each counterparty's valuation of each SBS in the SBS portfolio between the counterparties as of the close of business on the immediately preceding day and (3) resolve any discrepancy in valuations or material terms. See 17 CFR 240.15Fi-1(l).

portfolio reconciliations based on the size of the SBS portfolio with the applicable counterparty, ranging from once each business day (for SBS portfolios that include 500 or more SBS), to once each week (for SBS portfolios that include more than 50 but fewer than 500 SBS on any business day during the week), to once each calendar quarter (for SBS portfolios that include no more than 50 SBS at any time during the calendar quarter).<sup>57</sup> Exchange Act Rule 15Fi-3(b) requires each SBS Entity to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it engages in portfolio reconciliation for all SBS with non-SBS Entity counterparties, with the frequency of such portfolio reconciliations ranging from once each calendar quarter (for SBS portfolios that include more than 100 SBS at any time during the calendar quarter) to once annually (for SBS portfolios that include no more than 100 SBS at any time during the calendar year).<sup>58</sup>

FINRA acknowledges that the portfolio reconciliation requirements in Exchange Act Rule 15Fi-3 differ in some respects from the customer account statement requirements under FINRA Rule 2231.<sup>59</sup> For example, the frequency of portfolio reconciliations varies as described above, while customer account statements must be delivered at least quarterly. In addition, as described above, an SBS Entity must have policies and procedures in place to ensure that it engages in portfolio reconciliation with non-SBS Entity counterparties, while a member must provide a customer account statement to each customer unless a specific exception under FINRA Rule 2231(b) applies. However, FINRA believes that, while not identical, Exchange Act Rule 15Fi-3 serves analogous purposes to FINRA Rule 2231, such that requiring members that are SBS Entities to also provide customer account statements for accounts holding solely SBS and

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<sup>57</sup>     See 17 CFR 240.15Fi-3(a).

<sup>58</sup>     See 17 CFR 240.15Fi-3(b).

<sup>59</sup>     See Notice at 26091.



related collateral would be unnecessarily duplicative.<sup>60</sup> Accordingly, FINRA believes to promote regulatory clarity and avoid unnecessary duplication, proposed FINRA Rule 0180(f) would provide an exception from FINRA Rule 2231 in the limited circumstances where the member is acting in its capacity as an SBS Entity and the account holds solely SBS and collateral posted as margin in connection with such SBS.<sup>61</sup> FINRA states that collateral in a customer's account would be included in account statements provided under FINRA Rule 2231.<sup>62</sup> Therefore, in FINRA's view, the proposed rule change includes as a condition to the proposed exception that the member comply with Exchange Act Rule 15Fi-3 with respect to an account qualifying for the exception and include collateral in the portfolio reconciliation and dispute resolutions requirements as applied to such an account.<sup>63</sup>

SBS Entities also are subject to Exchange Act Rule 15Fi-5, which requires them to establish, maintain, and follow written policies and procedures reasonably designed to ensure that it executes written SBS trading relationship documentation with each of its counterparties prior to, or contemporaneously with, executing an SBS with any counterparty.<sup>64</sup> In addition, SBS Entities that are also registered broker-dealers are subject to the SEC's recordkeeping requirements under Exchange Act Rule 17a-3, which require, among other things, certain records

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<sup>60</sup> Id.

<sup>61</sup> Id.

<sup>62</sup> Id.

<sup>63</sup> Id.

<sup>64</sup> See 17 CFR 240.15Fi-5; Risk Mitigation Release at 6372-6377. Such documentation also must include all terms governing the trading relationship between the SBS Entity and its counterparty, including, without limitation, certain terms specified in the rule. SBS Entities are also required to maintain records of SBS trading relationship documentation. See 17 CFR 17a-4(e)(12)(ii).

to be kept for each SBS account.<sup>65</sup> These SEC rules generally require SBS Entities to obtain and keep records of certain information in connection with their SBS accounts, including SBS-specific identifying information. FINRA believes that, while not identical to FINRA Rule 4512, these SEC rules serve analogous purposes, and that also applying FINRA Rule 4512 to SBS-only accounts would be duplicative.<sup>66</sup> Accordingly, in order to promote regulatory clarity and avoid unnecessary duplication, FINRA believes it is appropriate to provide an exception from FINRA Rule 4512 in the limited circumstances where the member is acting in its capacity as an SBS Entity and the account solely holds SBS and collateral posted as margin in connection with such SBS.<sup>67</sup> Both exceptions under proposed FINRA Rule 0180(f) would not apply to accounts holding SBS together with other securities or to members that are not also registered SBS Entities.

**G. Proposed Rule 0180(g) (Exception from FINRA Registration for Certain Associated Persons of Registered SBS Entities)**

Proposed FINRA Rule 0180(g) would provide that persons associated with a member whose functions are related solely and exclusively to SBS, and undertaken in such person's capacity as an associated person of an SBS Entity, are not required to be registered with FINRA.<sup>68</sup> Generally, FINRA Rule 1210 requires that each person engaged in the investment

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<sup>65</sup> See 17 CFR 240.17a-3; see generally Recordkeeping Release, *supra* note 13. FINRA states in particular Exchange Act Rule 17a-3(a)(9)(iv), which requires an SBS Entity to keep a record, for each SBS account, of the unique identification code of the counterparty, the name and address of the counterparty, and a record of the authorization of each person the counterparty has granted authority to transact business in the SBS account. See 17 CFR 240.17a-3(a)(9)(iv).

<sup>66</sup> See Notice at 26092.

<sup>67</sup> *Id.*

<sup>68</sup> This proposed exception is structured similarly to existing exceptions from registration for persons associated with a member whose functions are related solely and exclusively to certain other product types (such as municipal securities, commodities or security futures), as found in FINRA Rule 1230.

banking or securities business of a member must be registered with FINRA as a representative or principal in each category of registration appropriate to his or her functions and responsibilities as specified in FINRA Rule 1220. Individuals seeking to become registered with FINRA generally must pass an appropriate qualification examination, and registered individuals are subject to continuing education (“CE”) requirements under FINRA Rule 1240.<sup>69</sup> The exception from registration would apply only to individuals engaged solely in SBS activities on behalf of the SBS Entity (and potentially non-securities activities, such as swaps).<sup>70</sup> Under FINRA’s proposed exception, if an associated person of the SBS Entity engaged in any other securities activities in addition to SBS, that individual must register with FINRA in accordance with FINRA Rule 1210.<sup>71</sup> Associated persons of members that are not registered SBS Entities would also still be required to register with FINRA, even if those individuals engage solely in SBS activities.<sup>72</sup> Additionally, although individuals qualifying for the proposed exception would not be required to register with FINRA, they would remain associated persons of the member subject to all FINRA and SEC rules applicable to such associated persons, including fingerprinting requirements under Exchange Act Rule 17f-2.<sup>73</sup>

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<sup>69</sup> See Notice at 26092.

<sup>70</sup> Id.

<sup>71</sup> Id.

<sup>72</sup> FINRA states that associated persons of SBS Entities are not independently subject to registration, licensing or CE requirements. See id. at 26109, n.58. However, an SBS Entity is prohibited from permitting an associated person that is subject to a statutory disqualification to effect or be involved in effecting SBS on behalf of the SBS Entity. See 15 U.S.C. 78o-10(b)(6). The SEC’s SBS Entity registration rules also require an SBS Entity to certify that it neither knows, nor in the exercise of reasonable care should have known, of any such statutory disqualification. Such certifications must be supported by questionnaires or employment applications serving as the basis for background checks. See 17 CFR 240.15Fb6-2; Registration Process Release at 48973-79.

<sup>73</sup> See 17 CFR 240.17F-2.

FINRA stated that it structured this exception similarly to existing exceptions from registration for persons associated with a member whose functions are related solely and exclusively to certain other product types (such as municipal securities, commodities or security futures).<sup>74</sup> FINRA also stated that it based the proposed exception in Rule 0180(g) on its analysis of existing registration and related requirements, and its understanding that the number of associated persons that would qualify for the exception is limited.<sup>75</sup> FINRA stated that it will monitor developments with respect to the SBS activities of its members and will continue to consider whether it would be appropriate to tailor the registration and related requirements to SBS, for example through targeted SBS-related registration categories or the addition of SBS-specific content to qualification examinations or CE content.<sup>76</sup> FINRA stated that it will consider whether it would be appropriate to rescind the exception under proposed FINRA Rule 0180(g) in such circumstances.<sup>77</sup>

**H. Proposed Rule 0180(i) (Authority to Grant Exemptions from the Application of Rule 0180 upon Member Application) and 9610 (Application for Exemptive Relief)**

Proposed FINRA Rule 0180(i) would provide that, pursuant to the FINRA Rule 9600 Series (Procedures for Exemptions), FINRA may, taking into consideration all relevant factors, exempt a person unconditionally or on specified terms from the application of FINRA rules (other than an exemption from the general application of proposed FINRA Rule 0180(a)) to the person's SBS activities or positions, as it deems appropriate, consistent with the protection of

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<sup>74</sup> See Notice at 26092, n.57; see also FINRA Rule 1230.

<sup>75</sup> See Notice at 26092.

<sup>76</sup> Id.

<sup>77</sup> Id.

investors and the public interest.<sup>78</sup> FINRA believes it is appropriate and in the public interest to provide this exemptive authority so that FINRA can account for specific situations that may arise with respect to SBS in the future on a case-by-case basis.<sup>79</sup> In formulating the proposed rule change, FINRA stated that it consulted with its members and reviewed its rulebook to determine whether continuing exceptions from any of its rules are appropriate.<sup>80</sup> FINRA stated that it is proposing FINRA Rule 0180(i) in recognition that the SBS market continues to evolve and that particular circumstances may arise in which applying specific FINRA rules not otherwise covered by the proposed exceptions to SBS activities may not be appropriate or feasible.<sup>81</sup>

As proposed, FINRA would consider written applications for exemptive relief, on a rule-by-rule and member-by-member basis, under the existing process set forth in FINRA Rule 9610.<sup>82</sup> Rule 9610 requires a member seeking exemptive relief to file a written application with the appropriate department or staff of FINRA containing, among other things, a detailed statement of the grounds for granting an exemption from the application of a specific FINRA rule.<sup>83</sup> Pursuant to FINRA Rule 9620, FINRA staff is then required to issue a written decision setting forth its findings and conclusions, which may be made publicly available.<sup>84</sup> A member would have the ability to appeal such a decision pursuant to FINRA Rule 9630.<sup>85</sup> FINRA stated

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<sup>78</sup> See Notice at 26093.

<sup>79</sup> Id.

<sup>80</sup> Id.

<sup>81</sup> Id.

<sup>82</sup> Id.

<sup>83</sup> See FINRA Rule 9610(a) and (b).

<sup>84</sup> See Notice at 26093. FINRA would consider any such application based on the specific circumstances described in the application and whether the requested exemptive relief would be consistent with the protection of investors and the public interest. Id. at 26093, n.66.

<sup>85</sup> Id. at 26093.

that it expects to apply heightened scrutiny to applications for exemptive relief from members that are not also registered with the SEC as SBS Entities, and therefore not subject to the SEC's regulatory framework for SBS.<sup>86</sup> FINRA believes it is appropriate and in the public interest to provide this exemptive authority so that FINRA can account for specific situations that may arise with respect to SBS in the future on a case-by-case basis.<sup>87</sup>

Finally, FINRA proposed a conforming change to Rule 9610 to add Rule 0180 to the list of over 30 rules pursuant to which FINRA already has exemptive authority.<sup>88</sup>

### **I. Financial Responsibility and Operational Requirements**

In June 2019, the Commission adopted final capital, margin and segregation requirements for SBS Entities, along with amendments to the existing capital and segregation requirements for broker-dealers, in the Capital, Margin, and Segregation Release.<sup>89</sup> As with other Title VII rulemakings, the SEC aligned the compliance date for the amendments under the Capital, Margin, and Segregation Release with the SBS Entity registration compliance date.<sup>90</sup> Among other things, the Capital, Margin, and Segregation Release amended the existing net capital rule for broker-dealers, Exchange Act Rule 15c3-1,<sup>91</sup> in two key respects relevant to FINRA's rules:

- First, the SEC adopted new minimum net capital requirements for broker-dealers that are also registered as SBSs, but that do not operate pursuant to the alternative net capital

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<sup>86</sup> Id.

<sup>87</sup> Id.

<sup>88</sup> See FINRA Rule 9610(a); see also Notice at 26093.

<sup>89</sup> See Capital, Margin, and Segregation Release, supra note 13.

<sup>90</sup> See id. at 43954.

<sup>91</sup> See 17 CFR 240.15c3-1.

(“ANC”) requirements of Exchange Act Rule 15c3-1 (“Non-ANC Firms”).<sup>92</sup> Non-ANC Firms that are also registered as SBSs must comply with a new minimum dollar net capital requirement and a new component for determining their minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the broker-dealer).<sup>93</sup> These changes do not apply to broker-dealers that operate pursuant to the ANC requirements of the rule (“ANC Firms”). These new minimum net capital requirements also do not impact Non-ANC Firms that are not also registered as SBSs, regardless of whether such Non-ANC Firms engage in SBS activities.<sup>94</sup>

- Second, the SEC changed the minimum net capital requirements for ANC Firms, regardless of whether they transact in SBS. For ANC Firms, the SEC increased the minimum dollar net capital requirement, added a new component for determining the minimum capital requirement that is based on a percentage of initial margin computed for SBS (in addition to other minimum requirements applicable to the broker-dealer),

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<sup>92</sup> Generally, a broker-dealer may apply to the SEC for authorization to use the alternative method for computing net capital contained in Appendix E to Exchange Act Rule 15c3-1. See 17 CFR 240.15c3-1(a)(7). Such broker-dealers are known as “ANC broker-dealers.” There are currently five approved ANC broker-dealers. See SEC, Broker-Dealers Using the Alternative Net Capital Computation under Appendix E to Rule 15c3-1, available at <https://www.sec.gov/tm/broker-dealers-alternative-net-capital-computation>. Other broker-dealers are known as non-ANC broker-dealers and must compute net capital pursuant to the provisions of Exchange Act Rule 15c3-1. See Notice at 26093.

<sup>93</sup> See 17 CFR. 240.15c3-1(a)(10).

<sup>94</sup> For example, the new minimum net capital requirements do not apply to a Non-ANC Firm engaged in SBS dealing activity below the de minimis threshold for SBS registration, or to a Non-ANC Firm engaged in SBS brokerage activity or entering into non-dealing SBS transactions (e.g., hedging). FINRA stated that the SEC also adopted new minimum capital requirements for MSBSPs, including that such entities must at all times have and maintain a tangible net worth. See Capital, Margin, and Segregation Release at 43906-07. FINRA does not believe any changes to FINRA rules are necessary with respect to the new MSBSP capital requirements. See Notice at 26094, n.71.

increased the minimum tentative net capital requirement and amended the early warning notification requirement for tentative net capital.<sup>95</sup>

FINRA Rule 4120 (Regulatory Notification and Business Curtailment) sets forth certain early warning notification and business curtailment requirements if a member's capital falls below certain thresholds. Specifically, FINRA Rule 4120(a) requires each carrying or clearing member to notify FINRA if its net capital falls below certain specified levels.<sup>96</sup> FINRA Rule 4120(b) allows FINRA to restrict a member from expanding its business in certain circumstances and FINRA Rule 4120(c) allows FINRA to require a member to reduce its business if its net capital falls below certain specified levels (generally lower than those required for notification under FINRA Rule 4120(a)). According to FINRA, these requirements are based on the minimum capital requirements applicable to a member broker-dealer under Exchange Act Rule 15c3-1.<sup>97</sup> FINRA believes it is necessary to amend FINRA Rule 4120 to conform the rule to the new and increased minimum capital requirements for Non-ANC Firms that are also registered as SBSDs and for ANC Firms, as described above.<sup>98</sup>

FINRA Rule 4120(a) requires each carrying or clearing firm to promptly, but in any event within 24 hours, notify FINRA in writing if its net capital falls below any of the

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<sup>95</sup> See 17 CFR 240.15c3-1(a)(7).

<sup>96</sup> As discussed below, FINRA also proposed to apply all requirements in the FINRA Rule 4000 Series applicable to carrying or clearing firms to members that act as principal counterparty to an SBS, clear or carry an SBS, guarantee an SBS or otherwise have financial exposure to an SBS. See Notice at 26094, n.73.

<sup>97</sup> See Notice at 26094.

<sup>98</sup> As noted above, the SEC did not amend Exchange Act Rule 15c3-1 to apply increased minimum capital requirements to Non-ANC Firms that engage in SBS activities but that are not registered SBSDs. FINRA is therefore not proposing to amend FINRA Rule 4120 to impose any additional minimum thresholds on such members. However, FINRA states that, as a general matter, FINRA Rule 4120 would apply to all members that engage in SBS transactions (and any related transactions) because net capital is a holistic calculation based on a firm's liquid net worth, which includes all of a firm's activities. See Notice at 26094, n.74.



percentages specified in subparagraphs (A) through (F) of FINRA Rule 4120(a)(1). The proposed rule change would modify subparagraph (D), which applies to ANC Firms, and also add new subparagraph (E), applicable to Non-ANC Firm members that are also registered as SBSDs.<sup>99</sup>

Prior to the amendments in the Capital, Margin and Segregation Release, Exchange Act Rule 15c3-1(a)(7)(i) required an ANC Firm to maintain minimum tentative net capital of not less than \$1 billion and minimum net capital of not less than \$500 million. In addition, Exchange Act Rule 15c3-1(a)(7)(ii) required an ANC Firm to provide an “early warning” notice to the Commission when its tentative net capital fell below \$5 billion (or a lower threshold, if the Commission has granted an ANC Firm’s application to use such lower threshold). Subparagraph (D) of FINRA Rule 4120(a) is based on these net capital requirements, requiring notification to FINRA if the member is an ANC Firm and (i) its tentative net capital under Exchange Act Rule 15c3-1(c)(15) is less than 50 percent of the early warning notification amount required by Exchange Act Rule 15c3-1(a)(7)(ii) or (ii) its net capital is less than \$1.25 billion. In other words, notification to FINRA is required if an ANC Firm’s tentative net capital falls below \$2.5 billion (or a lower amount, if the ANC Firm has been permitted to use a lower early warning notice threshold), which is half of the SEC’s early warning notification amount, or its net capital falls below \$1.25 billion, which is 2.5 times the SEC’s net capital requirement for ANC Firms.<sup>100</sup>

In the Capital, Margin, and Segregation Release, the Commission amended the net capital requirements for ANC Firms in three ways. First, the Commission raised the tentative net capital requirement for ANC Firms from \$1 billion to \$5 billion. Second, the Commission raised the minimum net capital requirement for ANC Firms from \$500 million to the greater of \$1 billion

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<sup>99</sup> The proposed rule change would also make non-substantive and conforming changes to other subparagraphs of FINRA Rule 4120(a) to reflect the insertion of new subparagraph (E), update cross-references to SEC rules that have been amended and reflect FINRA rulebook format conventions.

<sup>100</sup> See Notice at 26094.

or the sum of the applicable ratio requirement under Exchange Act Rule 15c3-1(a)(1)<sup>101</sup> and two percent of the risk margin amount.<sup>102</sup> Third, the Commission raised the tentative net capital early warning notification threshold from \$5 billion to \$6 billion. In light of these increased capital requirements under the Commission's net capital rule, FINRA believes it is appropriate to also modify the thresholds for required notification to FINRA for ANC Firms under FINRA Rule 4120(a)(1)(D).<sup>103</sup> Specifically, under the proposed rule change, an ANC Firm would be required to notify FINRA if, in addition to the conditions currently prescribed under FINRA Rule 4120(a)(1)(A), (E) and (F):<sup>104</sup>

- its tentative net capital is less than 150 percent of the minimum tentative net capital amount required by Exchange Act Rule 15c3-1(a)(7)(i)(A) (i.e., \$5 billion, such that the notification amount would be \$7.5 billion),
- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/10<sup>th</sup> of its aggregate indebtedness and 150 percent of the required percentage of the risk margin amount, or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of the level

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<sup>101</sup> See 17 CFR 240.15c3-1(a)(7)(i)(A). Under Exchange Act Rule 15c3-1(a)(1)(i), a broker-dealer generally may not permit its aggregate indebtedness to exceed 1500 percent of its net capital. A broker-dealer may elect not to be subject to the aggregate indebtedness standard if it complies with an alternative method of computing net capital. See 17 CFR 240.15c3-1(a)(1)(ii).

<sup>102</sup> The "risk margin amount" means the total initial margin for SBS. See 17 CFR 15c3-1(c)(17). Exchange Act Rule 15c3-1(a)(7)(i)(A) provides that initially the requirement will be two percent of the risk margin amount. However, the SEC may issue an order raising the requirement to four percent on or after the third anniversary of the amended rule's compliance date and to eight percent on or after the fifth anniversary of the amended rule's compliance date. See 17 CFR 15c3-1(a)(7)(i)(A)(2) and (3) and 15c3-1(a)(7)(i)(B).

<sup>103</sup> See Notice at 26094.

<sup>104</sup> Id.

specified in Exchange Act Rule 17a-11(b)(2)<sup>105</sup> and 150 percent of the required percentage of the risk margin amount.

FINRA believes these modified thresholds are appropriately calibrated to provide FINRA with sufficient early warning that an ANC Firm's capital levels may be deteriorating.<sup>106</sup> By revising the early warning levels as proposed, FINRA believes the proposed rule change aligns the historical thresholds in FINRA Rule 4120(a) for early warning notification for ANC Firms with the revised capital requirements applicable to such firms under the Commission's amended rules.<sup>107</sup> Additionally, according to FINRA, ANC Firms historically maintain capital far in excess of the proposed amounts, so FINRA does not expect these levels to be problematic for firms to maintain.<sup>108</sup>

In the Capital, Margin, and Segregation Release, the Commission also adopted a new minimum net capital requirement for Non-ANC Firms that are also registered as SBSDs.<sup>109</sup> Specifically, a Non-ANC Firm that is registered as an SBSD must maintain minimum net capital of not less than the greater of \$20 million or the sum of the ratio requirements under Exchange Act Rule 15c3-1(a)(1) and two percent of the risk margin amount.<sup>110</sup> Accordingly, FINRA believes it is necessary to add corresponding new thresholds for required notification to FINRA

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<sup>105</sup> See 17 CFR 240.17a-11(b)(2). Exchange Act Rule 17a-11 requires broker-dealers to promptly notify the SEC after the occurrence of certain events. Exchange Act Rule 17a-11(b)(2) requires such notification for broker-dealers using the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii) when net capital is less than five percent of aggregate debit items under the Exchange Act Rule 15c3-3 reserve formula.

<sup>106</sup> See Notice at 26094.

<sup>107</sup> See Notice at 26094-95.

<sup>108</sup> Id. at 26095.

<sup>109</sup> See 17 CFR 15c3-1(a)(10).

<sup>110</sup> See Notice at 26095.

for Non-ANC Firms that are also registered as SBSBs under new FINRA Rule 4120(a)(1)(E).<sup>111</sup>

Specifically, under the proposed rule change, a Non-ANC Firm that is also a registered SBSB would be required to notify FINRA if, in addition to the conditions currently prescribed under FINRA Rule 4120(a)(1)(A), (E) and (F):

- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/10<sup>th</sup> of its aggregate indebtedness and 150 percent of the required percentage of the risk margin amount, or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of the level specified in Exchange Act Rule 17a-11(b)(2) and 150 percent of the required percentage of the risk margin amount.<sup>112</sup>

FINRA believes it is appropriate to include specific thresholds for early notification to FINRA based on the new minimum net capital requirements for Non-ANC Firms that are registered SBSBs.<sup>113</sup> FINRA also believes that the thresholds described above are appropriately calibrated to provide FINRA with sufficient early warning that such a firm's capital levels may be deteriorating.<sup>114</sup> By defining the early warning levels as proposed, the proposed rule change, in FINRA's view, aligns the historical thresholds in FINRA Rule 4120(a) for early warning notification with the new capital requirements applicable to Non-ANC Firms that are registered SBSBs under the SEC's amended rules.<sup>115</sup>

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<sup>111</sup> Id.

<sup>112</sup> Id.

<sup>113</sup> Id.

<sup>114</sup> Id.

<sup>115</sup> Id.

FINRA Rule 4120(b) allows FINRA to require a member that carries customer accounts or clears transactions to not expand its business during any period in which any of the conditions described in paragraph (a)(1) of FINRA Rule 4120 continue to exist for more than 15 consecutive business days, provided that such condition(s) has been known to FINRA or the member for at least five consecutive business days. Since the proposed rule change would modify the conditions specified in FINRA Rule 4120(a)(1) as described above, the triggers for the application of restrictions under FINRA Rule 4120(b) would be similarly affected. However, FINRA does not believe that any conforming changes are needed at this time to the restrictions on business expansion requirements under FINRA Rule 4120(b).<sup>116</sup> FINRA states that FINRA Rule 4120(b)(3)(A)-(G) includes a non-exclusive list of activities that may constitute an “expansion of business” for these purposes, and FINRA Rule 4120(b)(3)(H) provides that the term “expansion of business” may include such other activities as FINRA deems appropriate under the circumstances, in the public interest or for the protection of investors. FINRA believes that a member firm’s SBS activities would be within the scope of “other activities” contemplated by FINRA Rule 4120(b)(3)(H).<sup>117</sup>

FINRA Rule 4120(c) allows FINRA to require a member to reduce its business if its net capital falls below any of the percentages specified in subparagraphs (A) through (F) of FINRA Rule 4120(c)(1). Similar to the proposed modifications to FINRA Rule 4120(a) described above, the proposed rule change would modify subparagraph (D) of FINRA Rule 4120(c)(1),

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<sup>116</sup> Id.

<sup>117</sup> Id.

which applies to ANC Firms, and also add new subparagraph (E), applicable to Non-ANC Firm members that are also registered as SBSBs.<sup>118</sup>

Current subparagraph (D) of FINRA Rule 4120(c)(1) permits business curtailment if the member is an ANC Firm and (i) its tentative net capital under Exchange Act Rule 15c3-1(c)(15) is less than 40 percent of the early warning notification amount required by Exchange Act Rule 15c3-1(a)(7)(ii) or (ii) its net capital is less than \$1 billion. These thresholds are based on the broker-dealer net capital rule prior to the amendments in the Capital, Margin, and Segregation Release. As described above, the Commission amended the net capital requirements for broker-dealers in the Capital, Margin, and Segregation Release.<sup>119</sup> Accordingly, under the proposed rule change, a member that is an ANC Firm would be subject to the business curtailment provisions of FINRA Rule 4120(c)(1) if, in addition to the conditions currently prescribed under FINRA Rule 4120(c)(1)(A), (E) and (F):

- its tentative net capital is less than the amount specified under Exchange Act Rule 15c3-1(a)(7)(ii) (i.e., the early warning amount, \$6 billion),
- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/12th of its aggregate indebtedness and 125 percent of the required percentage of the risk margin amount, or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of one

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<sup>118</sup> The proposed rule change would also make non-substantive and conforming changes to other subparagraphs of FINRA Rule 4120(c)(1) to reflect the insertion of new subparagraph (E), update cross-references to SEC rules that have been amended and reflect FINRA rulebook format conventions. Similar non-substantive changes would be made to paragraph (b)(1) and Supplementary Material .01 to FINRA Rule 4120 to reflect FINRA rulebook format conventions. See id., n.87.

<sup>119</sup> See Capital, Margin, and Segregation Release, supra note 13.

percentage point below the level specified in Exchange Act Rule 17a-11(b)(2) and 125 percent of the required percentage of the risk margin amount.<sup>120</sup>

FINRA believes these modified thresholds are appropriately calibrated to provide FINRA with the ability to require ANC Firms to reduce their business when their capital levels have deteriorated to a level that may jeopardize their ability to continue to comply with their capital requirements.<sup>121</sup>

As described above, in the Capital, Margin, and Segregation Release, the Commission also added a new minimum net capital requirement for Non-ANC Firms that are also registered as SBSDs. Accordingly, the proposed rule change would add corresponding new thresholds for business curtailment for Non-ANC Firms that are also registered as SBSDs under new FINRA Rule 4120(c)(1)(E). Specifically, under the proposed rule change, a Non-ANC Firm that is also a registered SBSD would be subject to the business curtailment provisions of FINRA Rule 4120(c)(1) if, in addition to the conditions currently prescribed under FINRA Rule 4120(c)(1)(A), (E) and (F):

- the member is subject to the aggregate indebtedness requirement of Exchange Act Rule 15c3-1(a)(1)(i), and its net capital is less than the sum of 1/12th of its aggregate indebtedness and 125 percent of the required percentage of the risk margin amount,<sup>122</sup> or
- the member elects to use the alternative method of computing net capital pursuant to Exchange Act Rule 15c3-1(a)(1)(ii), and its net capital is less than the sum of one

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<sup>120</sup> See Notice at 26095.

<sup>121</sup> Id.

<sup>122</sup> See supra note 101.

percentage point below the level specified in Exchange Act Rule 17a-11(b)(2)<sup>123</sup> and 125 percent of the required percentage of the risk margin amount.<sup>124</sup>

FINRA believes it is appropriate to include specific thresholds for business curtailment based on the new minimum net capital requirements for Non-ANC Firms that are registered as SBSs.<sup>125</sup> FINRA also believes that the thresholds described above are appropriately calibrated to provide FINRA with the ability to require such firms to reduce their business when their capital levels have deteriorated to a level that may jeopardize their ability to continue to comply with their capital requirements.<sup>126</sup>

Lastly, FINRA states that FINRA Rule 4120(c)(3)(A)-(J) includes a non-exclusive list of activities that may constitute a “business reduction” for these purposes, and FINRA Rule 4120(c)(3)(K) provides that the term “business reduction” may include such other activities as FINRA deems appropriate under the circumstances, in the public interest or for the protection of investors.<sup>127</sup> FINRA believes that a member firm’s SBS activities would be within the scope of “other activities” contemplated by FINRA Rule 4120(c)(3)(K).<sup>128</sup>

In addition to these conforming changes to FINRA Rule 4120, the proposed rule change would apply FINRA’s financial and operational rules more broadly to firms that enter into, or otherwise have exposure to, SBS. Specifically, certain rules in the FINRA Rule 4000 Series (Financial and Operational Rules) include provisions that impose higher standards, or provide FINRA the authority to impose additional requirements, on firms that carry or clear transactions

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<sup>123</sup> See supra note 105.

<sup>124</sup> See Notice at 26095.

<sup>125</sup> Id.

<sup>126</sup> Id. at 26096.

<sup>127</sup> Id.

<sup>128</sup> Id.



or accounts (generally referred to as “carrying or clearing firms”). This “tiering” structure was built into certain rules so that firms that only introduce their customer accounts and do not have exposure to the settlement system are provided relief from the higher standards required of firms that carry or clear transactions and accounts. Below is a list of rules in the FINRA Rule 4000 Series where tiering has been employed for carrying or clearing firms and a brief description of the tiered requirements for such firms:

- FINRA Rule 4110 (Capital Compliance) includes requirements for carrying or clearing firms to keep greater net capital, seek permission for withdrawals of capital and seek approval for certain add-backs to net capital.
- FINRA Rule 4120 (Regulatory Notification and Business Curtailment) includes restrictions on expanding, or requirements to reduce business, if sufficient capital levels are not maintained.
- FINRA Rule 4521 (Notifications, Questionnaires and Reports) allows FINRA to collect additional data and require reporting of a material decline in tentative net capital.
- FINRA Rule 4522 (Periodic Security Counts, Verification and Comparison) requires more frequent security counts, verifications and comparisons than would be required under Exchange Act Rule 17a-13.
- Rule 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts) requires a record of primary and supervisory named individuals over general ledger bookkeeping accounts.<sup>129</sup>

According to FINRA, the intent of the tiering employed in these rules in the FINRA Rule 4000 Series is to impose higher capital, recordkeeping and operational standards on firms that carry or clear transactions and accounts, and therefore may have financial exposure to customers,

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<sup>129</sup>

Id.

other broker-dealers, central counterparties or others.<sup>130</sup> FINRA believes that similar considerations apply for members with exposure to SBS.<sup>131</sup> FINRA states that SBS are complex transactions that will, by their nature, require detailed recordkeeping, margining, legal agreements, collateral management, reconciliation and risk management.<sup>132</sup> FINRA therefore believes it is appropriate to also employ tiering in the FINRA Rule 4000 Series for members that enter into SBS on a principal basis or otherwise have financial exposure to SBS.<sup>133</sup> Specifically, under the proposed rule change, proposed FINRA Rule 0180(h) would provide that, for purposes of the FINRA Rule 4000 Series, all requirements that apply to a member that clears or carries customer accounts shall also apply to any member that acts as a principal counterparty to an SBS, clears or carries an SBS, guarantees an SBS or otherwise has financial exposure to an SBS.<sup>134</sup> FINRA believes that applying these higher standards when a member enters into SBS or otherwise has exposure to SBS is appropriate and consistent with the protection of investors and the public interest.<sup>135</sup>

#### **J. Margin Requirements**

As discussed above, in June 2019 the Commission adopted its final Capital, Margin, and Segregation Release.<sup>136</sup> Among other things, the Capital, Margin, and Segregation Release adopted new Exchange Act Rule 18a-3, which prescribes margin requirements for uncleared

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<sup>130</sup> Id.

<sup>131</sup> Id.

<sup>132</sup> Id.

<sup>133</sup> Id.

<sup>134</sup> Although this proposed tiering provision relates to the financial responsibility and operational rules, FINRA believes it should be included as a paragraph in proposed FINRA Rule 0180 so that all provisions relating to the treatment of SBS under FINRA rules are found in a single, consolidated rule. See id. at 26096, n.95.

<sup>135</sup> See id. at 26096.

<sup>136</sup> See Capital, Margin, and Segregation Release at 43954.

SBS for SBSDs for which there is not a prudential regulator (“nonbank SBSD”).<sup>137</sup> Generally, Exchange Act Rule 18a-3 requires a nonbank SBSD to calculate, for each account of an SBS counterparty as of the close of business of each day: (i) the amount of current exposure in the account (i.e., variation margin) and (ii) the initial margin amount for the account.<sup>138</sup> Under Exchange Act Rule 18a-3, variation margin is calculated by marking the position to market, while initial margin must generally be calculated using standardized haircuts, which are prescribed in Exchange Act Rule 15c3-1 for nonbank SBSDs that are registered broker-dealers.<sup>139</sup> Nonbank SBSDs may apply to the SEC for authorization to use models to calculate initial margin instead of the standardized haircuts (including the option to use the more risk sensitive methodology in Exchange Act Rule 15c3-1a), but nonbank SBSDs that are registered broker-dealers must use standardized haircuts to calculate initial margin for uncleared equity SBS.<sup>140</sup> Based on these calculations, Exchange Act Rule 18a-3 generally requires a nonbank SBSD to collect and deliver variation margin, and to collect (but not deliver) initial margin.<sup>141</sup> Exchange Act Rule 18a-3 also provides certain exceptions from the margin requirements, establishes thresholds and minimum transfer amounts, specifies collateral

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<sup>137</sup> See 17 CFR 240.18a-3. Exchange Act Rule 18a-3 also prescribes margin requirements for nonbank MSBSPs with respect to uncleared SBS. As discussed above, Exchange Act Rule 18a-3 generally requires SBSDs to collect or deliver variation margin, and also to collect initial margin, with respect to its SBS counterparties. However, Exchange Act Rule 18a-3 requires that a nonbank MSBSP only collect and deliver variation margin, without prescribing any initial margin requirement. See Capital, Margin, and Segregation Release at 43877. As discussed below, FINRA believes it is appropriate to apply variation margin and initial margin requirements to all of its members that transact in uncleared SBS. Therefore, proposed FINRA Rule 4240 would provide an exception for members that are registered as SBSDs (and therefore subject to the variation and initial margin requirements of Exchange Act Rule 18a-3), but not for members that are registered as MSBSPs. See Notice at 26096, n.97.

<sup>138</sup> See 17 CFR 240.18a-3(c)(1)(i); Capital, Margin, and Segregation Release at 43876.

<sup>139</sup> See 17 CFR 240.18a-3(d).

<sup>140</sup> See Capital, Margin, and Segregation Release at 43876.

<sup>141</sup> See 17 CFR 240.18a-3(c)(1)(ii).

requirements (including collateral haircuts), establishes risk monitoring requirements and includes other miscellaneous provisions, such as definitions. All nonbank SBSs, including nonbank SBSs that are FINRA members, are subject to the margin requirements set forth in Exchange Act Rule 18a-3.

The FINRA Rule 4200 Series sets forth margin requirements applicable to FINRA members. In particular, FINRA Rule 4210 describes the margin requirements that determine the amount of equity or “margin” customers are expected to maintain in their securities accounts, including margin requirements for equity and fixed income securities as well as options, warrants and security futures. Current FINRA Rule 4240 separately establishes an interim pilot program with respect to margin requirements for any transactions in CDS held in an account at a member (the “Interim Pilot Program”). Under current FINRA Rule 0180, FINRA Rule 4210 does not apply to members’ activities and positions with respect to SBS, but current FINRA Rule 4240 does apply to activities and positions within its scope. Therefore, to the extent that a FINRA member enters into SBS that are CDS, the margin requirements under the Interim Pilot Program apply to such SBS.<sup>142</sup> However, the Interim Pilot Program is a temporary rule, and SBS that are not CDS are not currently subject to any margin requirements under FINRA rules.<sup>143</sup>

The Interim Pilot Program was originally proposed by FINRA and approved by the Commission in 2009 specifically to address concerns arising from systemic risk posed by CDS.<sup>144</sup> Pending the SEC’s final implementation of the Title VII rulemakings, FINRA has extended the expiration date of the Interim Pilot Program a number of times, most recently in

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<sup>142</sup> For purposes of current FINRA Rule 4240, the term “credit default swap” includes any product that is commonly known to the trade as a “credit default swap” and is an SBS as defined pursuant to Section 3(a)(68) of the Exchange Act or the rules and guidance of the SEC and its staff. See FINRA Rule 4240(a).

<sup>143</sup> See Notice at 26097.

<sup>144</sup> See Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Notice of Filing and Order Approving File No. SR-FINRA-2009-012).

September 2021.<sup>145</sup> The Interim Pilot Program under current FINRA Rule 4240 is currently set to expire on April 6, 2022.<sup>146</sup>

In light of the finalization of the Commission’s margin requirements for nonbank SBSDs under Exchange Act Rule 18a-3 and the registration compliance date, FINRA believes it is appropriate and in the public interest for the Interim Pilot Program to expire and for FINRA to adopt a new margin rule specifically applicable to SBS.<sup>147</sup> Accordingly, under the proposed rule change, current FINRA Rule 4240 would be replaced by a new FINRA Rule 4240 that would prescribe margin requirements for SBS. Consistent with Exchange Act Rule 18a-3—and unlike the Interim Pilot Program—proposed new Rule 4240 would apply margin requirements to all SBS, not just CDS. However, proposed new FINRA Rule 4240 would not apply to any member that is registered as an SBS, as such members are subject to the margin requirements of Exchange Act Rule 18a-3. Additionally, proposed FINRA Rule 4240 would defer to registered clearing agencies to set the margin requirements for cleared SBS, and as such would only specify new variation margin and initial margin requirements for uncleared SBS. Therefore, the specific new margin requirements prescribed under proposed FINRA Rule 4240 would only apply to uncleared SBS transacted by FINRA members that are not registered as SBSs. FINRA believes that, by applying margin requirements in these circumstances, the proposed rule change would fill an important regulatory gap, protect FINRA members against counterparty credit risk,

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<sup>145</sup> See Extension Notice at 50392.

<sup>146</sup> See supra note 19.

<sup>147</sup> See Notice at 26097. FINRA states that, under the proposed rule change, proposed FINRA Rule 0180 would no longer provide an exception from current FINRA Rule 4210 applying to members’ activities and positions with respect to SBS. Absent additional changes, therefore, the general margin requirements under FINRA Rule 4210 would apply to SBS. However, as described above, FINRA proposed to specifically list SBS within the exceptions listed in FINRA Rule 4210, and adopt a separate, new FINRA Rule 4240 applicable to SBS. See id., n.106.

maintain a level playing field for members and prevent regulatory arbitrage.<sup>148</sup> As described in further detail below, the margin requirements under proposed FINRA Rule 4240 would be structurally aligned with the margin requirements that will apply to nonbank SBSs under Exchange Act Rule 18a-3, with certain modifications that FINRA believes are necessary given that such members will not be subject to the SEC's comprehensive regulatory framework for SBSs.<sup>149</sup> Thus, subject to certain exceptions described in the proposed rule, proposed FINRA Rule 4240 would require members that are not SBSs to collect and deliver variation margin on a daily basis to cover the member's current exposure to or from each uncleared SBS counterparty, and also to collect (but not deliver) initial margin from each SBS counterparty.

Proposed FINRA Rule 4240 is divided into a header followed by paragraphs (a) through (d). The header would specify the scope of the margin requirements under proposed FINRA Rule 4240. Paragraph (a) would describe the margin requirements for cleared SBS. Paragraph (b) would describe the margin requirements for uncleared SBS. Specifically, paragraph (b)(1) would set forth how variation margin must be calculated, paragraph (b)(2) would set forth how initial margin must be calculated, paragraph (b)(3) would prescribe the collection and delivery requirements for variation and initial margin, paragraph (b)(4) would specify the manner and time of collection or delivery of variation and initial margin, and paragraph (b)(5) would list certain exceptions from the margin requirements. Paragraph (c) would require members to employ specified risk monitoring procedures and guidelines for uncleared SBS. Finally, paragraph (d) would define certain terms used in proposed FINRA Rule 4240. Each of these aspects of the proposed rule change is described in further detail below.

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<sup>148</sup> See id. at 26097.

<sup>149</sup> Id.

Proposed FINRA Rule 4240 would be entitled “Security-Based Swap Margin Requirements.”<sup>150</sup> The header text to the rule would state that each member that is a party to an SBS with a customer, broker or dealer, or other Counterparty,<sup>151</sup> or who has guaranteed or otherwise become responsible for any other person’s SBS obligations, shall comply with the requirements of proposed FINRA Rule 4240, except that a member that is registered as an SBSD shall instead comply with Exchange Act Rule 18a-3. This provision of the proposed rule is intended to clarify that the margin requirements under proposed FINRA Rule 4240 apply in all circumstances where a member is a party to an SBS, regardless of the type of counterparty, and also where a member has financial exposure to an SBS, whether through a guarantee or other

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<sup>150</sup> In addition to the new provisions under proposed FINRA Rule 4240 discussed above, the implementation of new margin requirements for SBS under proposed FINRA Rule 4240 would also require a conforming change to FINRA Rule 4220 (Daily Record of Required Margin). FINRA Rule 4220 requires each member carrying securities margin accounts for customers to make a record each day of every case in which initial or additional margin must be obtained in a customer’s account. To ensure that similar records are maintained for SBS margin required under proposed new FINRA Rule 4240, the proposed rule change would update FINRA Rule 4220 to also require such records for each member subject to proposed FINRA Rule 4240.

In addition, the proposed rule change would add new Supplementary Material .06 to FINRA Rule 4210 to clarify that a Regulation T good faith account, other than a non-securities account, is a margin account for purposes of FINRA Rule 4210. This provision is intended merely to codify FINRA’s existing interpretation regarding the scope of FINRA Rule 4210. The proposed rule change would also include a parallel provision in new Supplementary Material .01 to proposed new Rule 4240.

Finally, the proposed rule change would make two other conforming changes to FINRA Rule 4210, including to add proposed new FINRA Rule 4240(e)(9) and to make a technical adjustment to FINRA Rule 4240(g)(2)(H). See id. at 26097-98, n.107.

<sup>151</sup> “Counterparty” would be defined under proposed FINRA Rule 4240(d)(5) to mean a person with whom a member has entered into an uncleared SBS. An “SBS” would be defined in proposed FINRA Rule 4240(d)(16) by reference to the definition of “security-based swap” under Section 3(a)(68) of the Exchange Act and “Uncleared” would be defined in proposed FINRA Rule 4240(d)(18) as an SBS that is not Cleared. Under proposed FINRA Rule 4240(d)(3), an SBS would be considered Cleared if it is cleared through a Clearing Agency by or on behalf of the member, and Clearing Agency would be defined under proposed FINRA Rule 4240(d)(4) as a clearing agency registered pursuant to Section 17A of the Exchange Act or exempted by the SEC from such registration by a rule or order pursuant to Section 17A of the Exchange Act.

arrangements under which the member is responsible for another person's SBS obligations. FINRA believes that this provision is necessary to ensure that the proposed margin requirements adequately protect member firms against counterparty credit risk, regardless of the specific manner through which the member has become exposed to such risk.<sup>152</sup> Additionally, as discussed above, this provision clarifies that members that are registered as SBSDs are not subject to the proposed margin requirements because they must comply with Exchange Act Rule 18a-3. FINRA believes it should defer to the SEC's margin framework for registered SBSDs rather than impose additional or different requirements on such entities.<sup>153</sup> Proposed FINRA Rule 4240(a), entitled "Cleared SBS Margin Requirements," would state that, except as provided in paragraph (b)(5) (i.e., specified exceptions from proposed FINRA Rule 4240, discussed below), the margin to be maintained on any Cleared SBS is the margin on such Cleared SBS required by the Clearing Agency through which such SBS is Cleared. As discussed above, this provision clarifies that proposed FINRA Rule 4240 defers to registered clearing agencies to set the margin requirements for cleared SBS. FINRA believes that it is appropriate to defer to clearing agencies to establish margin requirements for cleared SBS in light of the SEC's comprehensive regulation of clearing agencies, including their required margin levels, under the Exchange Act.<sup>154</sup>

Proposed FINRA Rule 4240(b), entitled "Uncleared SBS Margin Requirements," would set forth the substantive margin requirements applicable to members that are not SBSDs when such members transact in uncleared SBS. Paragraph (b)(1), entitled "Current Exposure Calculation," would require that, as of the close of business of each business day, the member

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<sup>152</sup> See id. at 26098.

<sup>153</sup> Id.

<sup>154</sup> Id.



calculate, with respect to each Uncleared SBS Account,<sup>155</sup> the Counterparty's Current Exposure to the member (if positive) or the member's Current Exposure to the Counterparty (if negative). Current Exposure would be calculated as an amount equal to the net Value<sup>156</sup> of all uncleared SBS in the Uncleared SBS Account plus the Value of all Variation Margin collected from the Counterparty minus the Value of all Variation margin delivered to the Counterparty.<sup>157</sup> This provision would define a member's Current Exposure for purposes of collecting or delivering Variation Margin under proposed FINRA Rule 4240(b)(3), discussed below, by taking into account the net Value of SBS in the Counterparty's account together with any Variation Margin

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<sup>155</sup> Under proposed FINRA Rule 4240(d)(19), an "Uncleared SBS Account" would be defined to mean an account with respect to a Counterparty consisting of all Uncleared SBS between the member and the Counterparty, together with long or short positions for Variation Margin in the form of securities collected or delivered, respectively, credit or debit balances for Variation Margin in the form of cash collected or delivered, respectively, and long positions or credit balances for Initial Margin collected in the form of securities or cash, respectively.

<sup>156</sup> "Value" would be defined in proposed FINRA Rule 4240(d)(20). Under this definition, the Value of one or more SBS would be the mid-market replacement cost for such SBS. The Value of a security position would be the current market value of such margin securities, as defined in FINRA Rule 4210(a)(2) and determined in accordance with FINRA Rule 4210(f)(1) (i.e., the provisions of FINRA's general margin rule used to determine the current market value of margin securities). Alternatively, a member could elect to determine the Value of margin securities collected as Variation Margin or Initial Margin by applying a haircut to the current market value of such securities equal to the margin requirement that would be applicable to them under FINRA Rule 4210 if they were held in the Counterparty's margin account (in which case, however, such margin securities would not be required to be themselves margined under proposed FINRA Rule 4240(b)(2)(A)(iii)). The Value of cash in U.S. dollars would be the amount of such cash, while the Value of freely convertible foreign currency would be the amount of U.S. dollars into which the currency could be converted, provided the currency is marked-to-market daily. See id. at 26098, n.110.

<sup>157</sup> Under proposed FINRA Rule 4240(d)(21), "Variation Margin" would be defined to mean the cash or margin securities collected from, or delivered to, a Counterparty in accordance with proposed FINRA Rule 4240(b)(3)(A), as discussed below. Under proposed FINRA Rule 4240(b)(2)(A)(iii), all securities deposited as Variation Margin for uncleared SBS would themselves be margined in accordance with FINRA Rule 4210, unless the member has chosen to haircut them for purposes of determining their Value.

that has already been collected or delivered. FINRA believes this calculation is consistent with the variation margin requirements under Exchange Act Rule 18a-3.<sup>158</sup>

Proposed FINRA Rule 4240(b)(2), entitled “Initial Margin Computation,” would require that, as of the close of business on each business day, the member compute the Initial Margin Requirement for each Uncleared SBS Account equal to the sum of the Initial Margin Requirements on the Uncleared SBS and securities positions in that Uncleared SBS Account. The remainder of proposed FINRA Rule 4240(b)(2) would describe how a member must calculate the Initial Margin Requirement, which is then used for purposes of collecting Initial Margin under proposed FINRA Rule 4240(b)(3), discussed below.<sup>159</sup> Under the proposed rule change, the Initial Margin Requirement would depend on the type of uncleared SBS involved, with different requirements depending on whether the uncleared SBS is (i) a “plain vanilla” CDS; (ii) a “plain vanilla” SBS other than an CDS (i.e., an SBS that is the economic equivalent of a margin account containing a portfolio of long or short positions in securities or options, such as a “plain vanilla” equity total return swap (“TRS”)); or (iii) any other type of SBS (e.g., a complex CDS or equity TRS that would not be considered “plain vanilla” under the proposed rule, including for example a CDS swaption, or a dividend swap). FINRA believes that differentiation as to initial margin requirements among these different types of SBS is

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<sup>158</sup> See id. at 26098.

<sup>159</sup> Under proposed FINRA Rule 4240(d)(9), the term “Initial Margin” would be defined to mean all cash or marginable securities, excluding Variation Margin, received by the member for a Counterparty’s Uncleared SBS Account or transferred to the Counterparty’s Uncleared SBS Account from another account at the member, including margin collected from a Counterparty in accordance with proposed FINRA Rule 4240(b)(3)(B), as discussed below, that in each case have not been returned to the Counterparty or applied to an obligation of the Counterparty. Under proposed FINRA Rule 4240(b)(2)(A)(iii), all securities deposited as Initial Margin for uncleared SBS would themselves be margined in accordance with FINRA Rule 4210, unless the member has chosen to haircut them for purposes of determining their Value.

appropriate and necessary given the unique characteristics and risks posed by different SBS products.<sup>160</sup>

Proposed paragraphs (b)(2)(A)(i) and (ii) would define the Initial Margin Requirements for uncleared plain vanilla CDS (referred to as “Basic CDS”)<sup>161</sup> and other uncleared “plain vanilla” SBS (referred to as “Basic SBS”),<sup>162</sup> respectively. First, the Initial Margin Requirement for an uncleared Basic CDS would generally be computed based on the term and spread of the uncleared Basic CDS, using the chart and offsets set out in Exchange Act Rule 15c3-1(c)(2)(vi)(P).<sup>163</sup> In FINRA’s view, the proposed rule would therefore follow Exchange Act Rule 18a-3(d)(1)(i) by determining the Initial Margin Requirement for uncleared Basic CDS using the haircuts applicable to such SBS under the SEC’s net capital rule.<sup>164</sup> FINRA believes

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<sup>160</sup> See id. at 26099.

<sup>161</sup> Under proposed FINRA Rule 4240(d)(1), a “Basic CDS” would be defined to mean a Basic Single Name Credit Default Swap or a Basic Narrow-Based Index Credit Default Swap. A Basic Single-Name Credit Default Swap would mean an SBS in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments issued, guaranteed or otherwise entered into by a third party (i.e., the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The term “Basic Single-Name Credit Default Swap” would also include a swap that, upon the occurrence of one or more specified credit events with respect to the Reference Entity, is physically settled by payment of a specified fixed amount by one party against delivery by the other party of eligible obligations of the Reference Entity. A Basic Narrow-Based Index Credit Default Swap would be defined to mean an SBS consisting of multiple component Basic Single-Name Credit Default Swaps. See id. at 26099, n.113.

<sup>162</sup> Under proposed FINRA Rule 4240(d)(2), a “Basic SBS” would be defined to mean an SBS, other than a CDS, under which each party is contractually obligated to provide the other the economic equivalent of a margin account containing a portfolio of long or short positions in securities or options (i.e., an “Equivalent Margin Account”). See id. at 26099, n.114.

<sup>163</sup> See 17 CFR 240.15c3-1(c)(2)(vi)(P). This provision of the SEC’s broker-dealer net capital rule prescribes the haircuts applicable to uncleared SBS.

<sup>164</sup> See Notice at 26099

that determining initial margin for CDS in this manner would promote regulatory consistency and reduce potential arbitrage.<sup>165</sup> Additionally, in FINRA’s view, the haircuts prescribed in Exchange Act Rule 15c3-1(c)(2)(vi)(P) are analogous to existing FINRA Rule 4240 margin requirements, so in effect the proposed requirements have already been used during the Interim Pilot Program.<sup>166</sup> Second, the Initial Margin Requirement for a Basic SBS would generally be computed by applying FINRA Rule 4210 to the Equivalent Margin Account. Since an uncleared Basic SBS would be the economic equivalent of a margin account that would otherwise be governed by the margin provisions of FINRA Rule 4210, FINRA believes it is appropriate to treat such SBS similarly.<sup>167</sup>

In addition, proposed FINRA Rule 4240(b)(2)(A) would permit the Initial Margin Requirements for both uncleared Basic CDS and uncleared Basic SBS to be computed based on a combination of multiple SBS and securities or options positions, as applicable and subject to certain conditions. Specifically, proposed FINRA Rule 4240(b)(2)(A)(i) would provide that, if the member has a netting or collateral agreement that is legally enforceable against the Counterparty and covers any combination of uncleared Basic CDS or securities specified in clause (iii), (iv) or (v) of Exchange Act Rule 15c3-1(c)(2)(vi)(P)(1) (i.e., specified offsetting debt securities), the member may compute the Initial Margin Requirement on such combination of positions equal to the “haircut” on that combination under Exchange Act Rule 15c3-1(c)(2)(vi)(P)(1). Proposed FINRA Rule 4240(b)(2)(A)(ii) would similarly provide that, if the member has a netting or collateral agreement that is legally enforceable against the Counterparty and covers any combination of uncleared Basic SBS, securities or options positions, the member

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<sup>165</sup> Id.

<sup>166</sup> Id.

<sup>167</sup> Id.

may compute the Initial Margin Requirement on the combination of such positions equal to the margin that FINRA Rule 4210 would require to be maintained on the combination of Equivalent Margin Accounts for such uncleared Basic SBS and securities or options positions. Proposed FINRA Rule 4240(b)(2)(B) would impose conditions on computing the Initial Margin Requirement using these combination methods, including that (i) securities positions must be in the Counterparty's uncleared SBS Account or margin account at the member; (ii) securities may not be included if the member has chosen to haircut them for purposes of determining their Value; (iii) options positions must be in the Counterparty's margin account at the member; (iv) no SBS, security or option positions may be included in more than one combination; and (v) no combinations may include securities or options positions for which reduced margin requirements are computed under FINRA Rule 4210(e)(1) (i.e., reduced margin requirements for offsetting long and short positions) or 4210(f)(2)(F)(ii) through (f)(2)(I) (i.e., various reduced margin requirements for certain options, including covered options and offsetting options positions).<sup>168</sup> FINRA believes these conditions would ensure that the Initial Margin Requirement calculated using the combination method is based on securities and options positions that the member actually has in its possession and does not reflect reductions in value that would inappropriately lower the margin requirement.<sup>169</sup> In addition, proposed FINRA Rule 4240(b)(2)(B) would provide that if the Initial Margin Requirement is computed on a combination as described above, the Initial Margin Requirement on the uncleared SBS included in the combination shall be reduced (but not below zero) by the aggregate maintenance margin requirements under FINRA Rule 4210 applicable to such margin account positions. FINRA believes that this provision

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<sup>168</sup> Id.

<sup>169</sup> Id.

would appropriately take into account margin already collected under FINRA Rule 4210 with respect to such positions.<sup>170</sup>

The proposed rule change would not specify Initial Margin Requirements for other uncleared SBS that do not qualify as Basic CDS or Basic SBS. Instead, proposed FINRA Rule 4240(b)(2)(A)(iv) would provide that the Initial Margin Requirement for any uncleared SBS other than a Basic CDS or Basic SBS would be determined in a manner approved by FINRA pursuant to proposed FINRA Rule 4240(b)(2)(C), which would permit a member to apply to FINRA for the approval of an Initial Margin Requirement for any other type of SBS. Under the proposed rule change, any such application would be required to:

- define the specific type of SBS covered by the application;
- describe the purpose(s) that the member and its Counterparties would have for entering that type of SBS;
- identify all variables that influence the value of that type of SBS;
- explain all risks of that type of SBS;
- propose a specific Initial Margin Requirement (not a margin model) for that type of SBS;
- explain how the proposed specific Initial Margin Requirement would adequately protect a member and its capital against each of those risks;

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<sup>170</sup> Id. In connection with this proposed provision of FINRA Rule 4240(b)(2)(B), the proposed rule change would also add a new paragraph (e)(9) to FINRA Rule 4210, entitled “Security-Based Swaps; SBS Offsets.” Specifically, where the Initial Margin Requirement on the combination of SBS and securities or options position in the margin account would be less than the FINRA Rule 4210 maintenance requirement on the margin account positions, proposed FINRA Rule 4210(e)(9) would reduce the FINRA Rule 4210 maintenance requirement on the margin account positions to equal the computed Initial Margin Requirement.

In addition, proposed FINRA Rule 4210(e)(9) would clarify that, except for SBS carried by a member in a portfolio margin account subject to the requirements of FINRA Rule 4210(g), as discussed below, margin requirements on SBS and positions in Uncleared SBS Accounts are determined by proposed FINRA Rule 4240, rather than FINRA Rule 4210. See id. at 26099, n.117.

- attach copies of the member’s SBS risk management procedures and describe the application of those procedures to that type of SBS; and
- provide the results of backtesting of the proposed specific Initial Margin Requirement over periods of significant volatility in the variables influencing the value of that type of SBS.<sup>171</sup>

Proposed FINRA Rule 4240(b)(2)(C) would further provide that, if FINRA approves any such application, the approval may be unconditional or conditional, including in the form of a time-limited pilot program; may approve the use of the specific Initial Margin Requirement only by the applicant; or may take the form of a Regulatory Notice or other communication approving the use of the specific margin requirements by members generally. Under proposed FINRA Rule 4240(b)(2)(C), no member would be permitted to become a party to an SBS other than a Basic CDS or Basic SBS unless FINRA has approved an Initial Margin Requirement for such member’s use with respect to that type of SBS. As described above, FINRA states that the Initial Margin Requirements for Basic CDS are based on the Commission’s treatment of such SBS under its net capital rule, while the Initial Margin Requirements for Basic SBS are based on the margin that would be required for a margin account that would be the economic equivalent of such SBS.<sup>172</sup> However, in FINRA’s view, other types of SBS—including CDS and equity TRS with complex features—may not be easily accommodated under these frameworks, and the specific risks that accompany such SBS may not be readily apparent or quantifiable to FINRA without additional information.<sup>173</sup> Moreover, as noted above, SBS can be complex financial instruments that pose substantial risks to members and margin serves as an important means of protecting member firms, and thereby their customers and investors, from such risks. FINRA

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<sup>171</sup> See Notice at 26100.

<sup>172</sup> Id.

<sup>173</sup> Id.

therefore believes that members that are not SBSDs (and therefore not subject to the SEC's comprehensive regulatory framework for registrants under Title VII of Dodd-Frank) should not be permitted to enter into other types of SBS unless and until FINRA has evaluated the risks of such SBS and approved margin requirements that adequately address such risks.<sup>174</sup> If FINRA determines that a proposed margin requirement does not adequately address the risks for a particular type of SBS, FINRA would not approve the application under proposed FINRA Rule 4240(b)(2)(C), and members would not be permitted to enter into such SBS. To FINRA's knowledge, this SBS activity by members that do not plan to register as SBSDs is relatively limited.<sup>175</sup>

Proposed FINRA Rule 4240(b)(3), entitled "Collection or Delivery of Variation and Initial Margin," would set forth a member's obligation to collect or deliver margin as calculated pursuant to proposed FINRA Rule 4240(b)(1) and (2), as described above. Paragraph (b)(3)(A) would require each member to deliver or return to each Counterparty cash or margin securities with a Value equal to the Counterparty's Current Exposure (if any) to the member, or collect or retrieve from the Counterparty cash or margin securities with a Value equal to the member's Current Exposure (if any) to the Counterparty. Paragraph (b)(3)(B) would require each member to collect from each Counterparty cash or margin securities with a Value at least equal to any Initial Margin Deficit.<sup>176</sup> Therefore, consistent with Exchange Act Rule 18a-3, proposed FINRA Rule 4240(b)(3) would require members that are not SBSDs to collect and deliver Variation

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<sup>174</sup> Id.

<sup>175</sup> Id.

<sup>176</sup> Under proposed FINRA Rule 4240(d)(10), the term "Initial Margin Deficit" would be defined as the amount, if any, by which (A) the sum of the Value of the Initial Margin in an Uncleared SBS Account and the Counterparty's Rule 4210 Excess is less than (B) the Initial Margin Requirement for the Uncleared SBS Account. A person's "Rule 4210 Excess" would be defined in proposed FINRA Rule 4240(d)(15) to mean the amount, if any, by which the equity (as defined in FINRA Rule 4210(a)(5)) in the Counterparty's margin account at the member exceeds the amount required by FINRA Rule 4210. See id. at 26100, n.118.



Margin, and also to collect (but not deliver) Initial Margin, in amounts determined pursuant to the provisions of FINRA Rule 4240(b)(1) and (2) as described above, for their transactions in uncleared SBS.<sup>177</sup>

Proposed FINRA Rule 4240(b)(4), entitled “Manner and Time of Collection or Delivery of Variation and Initial Margin; Prohibited Returns and Withdrawals,” would set forth additional detailed requirements and clarifications regarding the manner and time of collection or delivery of variation and initial margin, as calculated pursuant to proposed FINRA Rules 4240(b)(1) and (2) and collected or delivered in accordance with proposed FINRA Rule 4240(b)(3), as described above. Specifically, proposed FINRA Rule 4240(b)(4) would provide for the following:<sup>178</sup>

- Under proposed FINRA Rule 4240(b)(4)(A), margin would be deemed collected or returned to the member when it is received in the Counterparty’s Uncleared SBS Account at the member (or transferred to such account from another account at the member).
- Under proposed FINRA Rule 4240(b)(4)(B), margin would be deemed collected or returned to the Counterparty when it is transferred from the Counterparty’s Uncleared SBS Account at the member in accordance with the Counterparty’s instructions or agreement with the member, which could potentially include transfer to another account of the Counterparty carried by the member.
- Under proposed FINRA Rule 4240(b)(4)(C), margin would be required to be collected or delivered pursuant to proposed FINRA Rule 4240(b)(3) as promptly as possible, but in

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<sup>177</sup> To account for situations where a member is not the actual party to an SBS, but nonetheless has financial exposure for uncleared SBS (e.g., through a guarantee), proposed FINRA Rule 4240(b)(3)(C) would also require a member to collect both Variation Margin and Initial Margin from the party that has obligations under the uncleared SBS for which the member has responsibility, to the extent that such collection would be required if the member were a party to the uncleared SBS, unless the member can establish that such margin has been delivered to the other party. See id. at 26100, n.119.

<sup>178</sup> See id. at 26100.

any case no later than the close of business on the business day after the date on which the Current Exposure or Initial Margin Requirement was required to be computed in accordance with proposed FINRA Rule 4240(b)(1) or (2) (i.e., margin would generally be required to be delivered or collected on a T+1 basis). Further, unless FINRA has specifically granted the member additional time, a member that has not collected margin as required by the close of business on the third business day (i.e., by T+3) would be required to take prompt steps to liquidate positions in the Counterparty's Uncleared SBS Account to eliminate the margin deficiency.

- Proposed FINRA Rule 4240(b)(4)(D) would require a member to net the delivery or return of Variation Margin against the collection of Initial Margin, if applicable, and would further permit a member to net the return of Initial Margin against the collection or retrieval of Variation Margin, if applicable.
- Proposed FINRA Rule 4240(b)(4)(E) would prohibit a member from returning Initial Margin to a Counterparty, or permitting a Counterparty to make a withdrawal from the Counterparty's margin account, if doing so would create or increase an Initial Margin Deficit.

FINRA believes it is appropriate and consistent with the protection of member firms and investors to require margin for uncleared SBS to be delivered or collected, as applicable, on a T+1 basis, and to further require that uncleared SBS positions be liquidated if margin is not collected within a T+3 timeframe.<sup>179</sup> FINRA also believes the other clarifications described above are necessary to ensure that members and their uncleared SBS counterparties have a clear and consistent understanding of when and how margin must be delivered or collected under the proposed rule change.<sup>180</sup>

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<sup>179</sup> See id. at 26101.

<sup>180</sup> Id.

Proposed FINRA Rule 4240(b)(5), entitled “Exceptions,” would provide eight specific exceptions from a member’s general obligation to collect or deliver margin, as applicable, under proposed FINRA Rule 4240(b)(3), as described above. FINRA believes the proposed exceptions would further align the requirements of proposed FINRA Rule 4240 with the margin requirements applicable to SBSs under Exchange Act Rule 18a-3 and provide members with additional flexibility in managing their risk exposures, while still ensuring that the risks to members with respect to their uncleared SBS exposures are adequately addressed.<sup>181</sup> The proposed exceptions under FINRA Rule 4240(b)(5) would include the following:

- Clearing Agencies. A member would not be required to deliver Variation Margin to, or collect Initial Margin or Variation Margin from, any Clearing Agency, and would also not be required to deduct otherwise required Variation Margin or Initial Margin in the computation of its net capital under Exchange Act Rule 15c3-1 or, if applicable, FINRA Rule 4110(a). FINRA believes this exception is consistent with its determination to defer to Clearing Agency margin requirements with respect to Cleared SBS.<sup>182</sup>
- Legacy SBS. A member would be permitted to omit all (but not less than all) Legacy SBS with a Counterparty from the Counterparty’s Uncleared SBS Account when computing Current Exposure and the Initial Margin Requirement, provided that the member collects and delivers margin on Legacy SBS to the extent of its contractual rights and obligations to do so.<sup>183</sup> However, a member would be required to take a capital

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<sup>181</sup> Id.

<sup>182</sup> Id.

<sup>183</sup> Under proposed FINRA Rule 4240(d)(12), a “Legacy SBS” would be defined as an uncleared SBS entered into before April 6, 2022. See Amendment No. 1. Proposed FINRA Rule 4240(b)(2)(A)(iv) would also clarify that for any Legacy SBS for which proposed Rule 4240 does not specify an Initial Margin Requirement (i.e., an SBS other than a Basic CDS, Basic SBS or other SBS for which FINRA has approved specific

deduction under Exchange Act Rule 15c3-1 or, if applicable, FINRA Rule 4110(a), to reflect the amount of any margin that it would have otherwise been required to collect if the Legacy SBS had been included in the Counterparty's Uncleared SBS Account.

FINRA believes it is appropriate to provide a general exception for legacy SBS, as members would not be in a position to require their counterparties to legacy SBS to exchange margin under existing SBS agreements as would otherwise be required under proposed FINRA Rule 4240.<sup>184</sup> However, in such cases, FINRA believes it is appropriate to require a member to take a corresponding capital charge to account for the member's ongoing risk exposure under such SBS.<sup>185</sup>

- Multilateral Organizations. A member would not be required to deliver Variation Margin to, or collect Initial Margin or Variation Margin from, any Multilateral Organization.<sup>186</sup> However, a member would be required to take a capital deduction to reflect the amount of any margin that it would otherwise have been required to collect from such a

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margin requirements), the Initial Margin Requirement must be calculated using the applicable method specified in Exchange Act Rule 15c3-1(c)(2)(vi)(P). The Initial Margin Requirement for Legacy SBS calculated under this provision would be used for purposes of determining the appropriate corresponding capital charge, as well as to determine the Initial Margin Requirement for a Legacy SBS to the extent that a member elects not to utilize the Legacy SBS exception under proposed FINRA Rule 4240(b)(5). See id. at 26101, n.120.

<sup>184</sup> See id. at 26101.

<sup>185</sup> Id.

<sup>186</sup> Under proposed FINRA Rule 4240(d)(13), a "Multilateral Organization" would be defined to mean the Bank for International Settlements, the European Stability Mechanism, the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, or any other multilateral development bank that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member. See id. at 26101, n.121.

Multilateral Organization. FINRA believes it is appropriate to follow Exchange Act Rule 18a-3 by providing an exception for Multilateral Organizations and requiring the risk posed by such SBS to be accounted for in a member's capital computations.<sup>187</sup>

- Financial Market Intermediaries. A member would not be required to collect Initial Margin from a Counterparty that is a Financial Market Intermediary (but would still be required to collect or deliver Variation Margin, as applicable).<sup>188</sup> In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have otherwise been required to collect from such Financial Market Intermediary. A Counterparty that is a Financial Market Intermediary generally would be subject to a comprehensive regulatory framework, including capital requirements. FINRA therefore believes it is appropriate to account for the reduced counterparty credit risk posed by such Counterparties by permitting a member to take a capital charge in lieu of requiring such Counterparties to post Initial Margin.<sup>189</sup> However, FINRA continues to believe that Variation Margin should be exchanged with such Counterparties to account for ongoing the market risk posed by such uncleared SBS.<sup>190</sup>
- Sovereign Counterparties. A member would generally be required to deliver Variation Margin to, and collect Initial Margin or Variation Margin from, a Sovereign Counterparty.<sup>191</sup> However, under proposed FINRA Rule 4240(b)(5)(E), if the member

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<sup>187</sup> See id. at 26101.

<sup>188</sup> Under proposed FINRA Rule 4240(d)(8), a “Financial Market Intermediary” would be defined to mean an SBS, swap dealer, broker or dealer, FCM, bank, foreign bank, or foreign broker or dealer. See id. at 26101, n.122.

<sup>189</sup> See id. at 26101.

<sup>190</sup> Id.

<sup>191</sup> Under proposed FINRA Rule 4240(d)(17), a “Sovereign Counterparty” would be defined as a Counterparty that is a central government (including the U.S. government) or an agency, department, ministry or central bank of a central government. See id. at 26101, n.122.

has determined pursuant to policies and procedures or credit risk models established pursuant to Exchange Act Rule 15c3-1(c)(2)(vi)(l) that the Sovereign Counterparty has only a minimal amount of credit risk, the member would not be required to collect Initial Margin from such Sovereign Counterparty (but would still be required to collect or deliver Variation Margin, as applicable). In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have otherwise been required to collect from such Sovereign Counterparty. As for Financial Market Intermediaries, FINRA believes it is appropriate to account for the reduced counterparty credit risk posed by highly creditworthy Sovereign Counterparties by permitting a member to take a capital charge in lieu of requiring such Counterparties to post Initial Margin.<sup>192</sup> However, FINRA continues to believe that Variation Margin should be exchanged with such Counterparties to account for ongoing the market risk posed by such uncleared SBS.<sup>193</sup>

- Majority Owners; ANC Firms Transacting with Majority Owners or Registered or Foreign SBS Dealers Under Common Ownership. FINRA states that it understands that members may enter into uncleared SBS with affiliated entities for a variety of reasons, including for risk management purposes.<sup>194</sup> FINRA does not believe a broad exception from the proposed margin requirements for uncleared SBS with all affiliates would adequately account for the risks posed to its members by uncleared SBS in such circumstances.<sup>195</sup> However, FINRA does believe that two specific, more limited

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<sup>192</sup> See id. at 26101-102.

<sup>193</sup> Id. at 26102.

<sup>194</sup> Id.

<sup>195</sup> Id.

exceptions for SBS entered into with certain affiliates would be appropriate.<sup>196</sup> First, under proposed FINRA Rule 4240(b)(5)(F), a member would not be required to collect Initial Margin from a Counterparty that is a direct or indirect owner of a majority of the equity and voting interests in the member (a “Majority Owner”) (but would still be required to collect or deliver Variation Margin, as applicable). In such case, a member would be required to take a capital deduction to reflect the amount of any Initial Margin that it would have otherwise been required to collect from such Majority Owner. Second, under proposed FINRA Rule 4240(b)(5)(G), a member that is an ANC Firm would not be required to collect Initial Margin from a Counterparty that is a Majority Owner or a Registered or Foreign SBS Dealer under common ownership (but would still be required to collect or deliver Variation Margin, as applicable).<sup>197</sup> In such case, an ANC Firm member would be required to take a deduction for credit risk on such transactions computed in accordance with Exchange Act Rule 15c3-1e(c).<sup>198</sup> FINRA believes that the proposed exception from the Initial Margin Requirements for uncleared SBS with Majority Owners, provided that the member takes a capital charge in lieu of collecting

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<sup>196</sup> Id.

<sup>197</sup> Under proposed FINRA Rule 4240(d)(14), a “Registered or Foreign SBS Dealer” would be defined to mean (i) any person registered with the SEC as an SBSB or (ii) any foreign person if the SEC has made a substituted compliance determination under Exchange Act Rule 3a71-6(a)(1) that compliance by an SBSB or class thereof with specified requirements of a foreign regulatory system that are applicable to such foreign person may satisfy the capital requirements of Section 15F(e) of the Exchange Act and Exchange Act Rule 18a-1 that would otherwise apply to such SBSB or class thereof. Therefore, the definition would cover registered SBSBs and entities that are subject to equivalent SBSB capital requirements in a foreign jurisdiction. See id. at 26102, n.124.

<sup>198</sup> FINRA states that an ANC Firm transacting with a Counterparty that is its Majority Owner would also benefit from the general exception for collecting Initial Margin from Majority Owners, as described above. However, under this additional exception, an ANC Firm would be permitted to take only a deduction for the credit risk on its transactions with Majority Owner counterparties as calculated in accordance with Exchange Act Rule 15c3-1e, rather than the full amount of the Initial Margin Requirement that would otherwise have applied. See id. at 26102, n.125.

Initial Margin, would adequately protect members in such circumstances due to the lower risk presented by Majority Owners, which typically must satisfy capital and other requirements applicable to bank holding companies and similar entities.<sup>199</sup> FINRA also believes that the proposed exception for ANC Firms with respect to SBS with Majority Owners and Registered or Foreign SBS Dealer affiliates, provided that the member takes a corresponding credit risk charge, would adequately protect such members while reducing potential competitive disparity as between ANC Firms that are registered as SBSDs (and therefore subject to Exchange Act Rule 18a-3) and ANC Firms that are not registered as SBSDs (and therefore would be subject to proposed FINRA Rule 4240 with respect to their uncleared SBS).<sup>200</sup>

- Portfolio Margin. Proposed FINRA Rule 4240(b)(5)(H) would provide that proposed FINRA Rule 4240 would not apply to any unlisted derivative, as defined in FINRA Rule 4120(g)(2)(H), carried by the member in a portfolio margin account subject to the requirements of FINRA Rule 4210(g) if such unlisted derivative is of a type addressed in the comprehensive written risk analysis methodology filed by the member with FINRA in accordance with FINRA Rule 4210(g)(1).<sup>201</sup> In addition, proposed FINRA Rule 4240 would not apply to any SBS carried in a commodity account or other account under the jurisdiction of the CFTC in accordance with an SEC rule, order or no-action letter permitting SBS and swaps to be carried and portfolio margined together in such an account. According to FINRA, portfolio margining provides members with the flexibility to manage their risk exposures based on a broader view of their overall

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<sup>199</sup> See id. at 26102.

<sup>200</sup> Id.

<sup>201</sup> FINRA is also proposing a technical adjustment to the definition of “unlisted derivative” under FINRA Rule 4210(g)(2)(H) to clarify that, to qualify under the definition, the option, forward contract or SBS must be able to be valued by a theoretical pricing model that is approved by the SEC for valuing that type of options, forward contract or SBS.



relationship with a particular Counterparty.<sup>202</sup> FINRA believes it is appropriate to provide an exception from proposed FINRA Rule 4240 for any SBS in a portfolio margin account if the SBS is of a type whose risk is appropriately addressed by an approved theoretical pricing model (e.g., TIMS) and covered by portfolio risk management procedures filed by the member with FINRA, as well as for SBS permitted by the SEC to be portfolio margined in a commodity account.<sup>203</sup> In these circumstances, in FINRA's view, the risks presented by such SBS would already be subject to a comprehensive risk management framework, and therefore FINRA does not believe it is necessary to apply the proposed new margin requirements to such SBS.<sup>204</sup>

Proposed FINRA Rule 4240(c), entitled "Risk Monitoring Procedures and Guidelines," would require members to monitor the risk of any Uncleared SBS Accounts and maintain a comprehensive risk analysis methodology for assessing the potential risk to the member's capital over a specified range of possible market movements over a specified time period. For purposes of this requirement, members would be required to employ the following risk monitoring procedures and guidelines:<sup>205</sup>

- obtaining and reviewing the required documentation and financial information necessary for assessing the amount of credit to be extended to SBS Counterparties;
- determining and documenting the legal enforceability of netting or collateral agreements, including enforceability in the event a Counterparty becomes subject to bankruptcy or other insolvency proceedings;

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202 Id.

203 Id.

204 Id.

205 Id.

- assessing the determination, review and approval of credit limits to each Counterparty, and across all Counterparties;
- monitoring credit risk exposure to the member from SBS, including the type, scope and frequency of reporting to senior management;
- the use of stress testing of accounts containing SBS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
- managing the impact of credit extended related to SBS contracts on the member's overall risk exposure;
- determining the need to collect additional margin from a particular customer or broker or dealer, including whether that determination was based upon the creditworthiness of the customer or broker or dealer and/or the risk of the specific contracts;
- determining the need for higher margin requirements than required by proposed FINRA Rule 4240 and formulating the member's own margin requirements, including procedures for identifying unusually volatile positions, concentrated positions (with a particular Counterparty and across all Counterparties and customers), or positions that cannot be liquidated promptly;
- monitoring the credit exposure resulting from concentrated positions with a single Counterparty and across all Counterparties, and during periods of extreme volatility;
- identifying any Uncleared SBS Accounts with intraday risk exposures that are not reflected in their end of day positions (e.g., Uncleared SBS Accounts that frequently establish positions and then trade out of, or hedge, those positions by the end of the day) and collecting appropriate margin to address those intraday risk exposures;
- identifying any Uncleared SBS Account that, in light of current market conditions, could not be promptly liquidated for an amount corresponding to the Current Exposure computed with respect to such account and determining the need for higher margin requirements on such accounts or the positions therein;

- maintaining sufficient Initial Margin in the accounts of each Counterparty to protect against the largest individual potential future exposure of an Uncleared SBS in such Counterparty's Uncleared SBS Account, as measured by computing the largest maximum possible loss that could result from the exposure; and
- increasing the frequency of calculations of Current Exposure and Initial Margin Requirements during periods of extreme volatility and for accounts with concentrated positions.

Proposed FINRA Rule 4240(c) would further require a member to review, in accordance with the member's written procedures, at reasonable periodic intervals, the member's SBS activities for consistency with these risk monitoring procedures and guidelines, and to determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data.

In FINRA's view, the risk monitoring procedures and guidelines under proposed FINRA Rule 4240(c) are analogous to the risk monitoring and procedure requirements applicable to nonbank SBSDs with respect to their uncleared SBS transactions under Exchange Act Rule 18a-3.<sup>206</sup> These requirements are also based in part on aspects of FINRA Rule 4210, including procedures related to the need for additional margin under FINRA Rule 4210(d) and the portfolio margin risk monitoring requirements under FINRA Rule 4210(g)(1). In FINRA's view, SBS are complex financial instruments that may expose a member to significant risks, including, for example, market risk, counterparty credit risk, operational risk and legal risk.<sup>207</sup> FINRA accordingly believes it is appropriate and necessary, and consistent with the protection of

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<sup>206</sup> See id. at 26103; see also 17 CFR 240.18a-3(e); Capital, Margin, and Segregation Release at 43930.

<sup>207</sup> See Notice at 26103.

investors, for members with exposure to uncleared SBS to maintain a comprehensive risk monitoring program, including the specific elements described above, to address such risks.<sup>208</sup>

#### **K. Effective Date**

As discussed above in Section II.A., current FINRA Rule 0180 temporarily excepts the application of most FINRA rules to the SBS activities of its members. Now that the Commission has finalized the majority of its Title VII rulemakings, FINRA believes it is appropriate and in the public interest for the current temporary FINRA Rule 0180 to expire and for FINRA to clarify the application of FINRA rules to SBS through a permanent FINRA rule.<sup>209</sup> Additionally, since FINRA filed its proposed rule change, as modified by Amendment No. 1, the Commission's regulatory framework governing SBS Entities has gone into effect. FINRA is proposing to amend FINRA Rules 0180, 4120, 4210, 4220, 4240 and 9610 to take into account members' SBS activities.<sup>210</sup> FINRA states that if the proposed rule change, as modified by Amendment No. 1, is approved by the Commission, the effective date for the proposed amendments to FINRA Rules 0180, 4120 and 9610 will be February 6, 2022, and the effective date for the proposed amendments to FINRA Rules 4210, 4220 and 4240 will be April 6, 2022.<sup>211</sup>

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<sup>208</sup> Id.

<sup>209</sup> See Notice at 26086.

<sup>210</sup> See id.

<sup>211</sup> A commenter expressed concern as to FINRA's initial proposed effective date for the proposed rule change. See SIFMA Letter at 1-3, 11. In response, on August 9, 2021, FINRA filed Amendment No. 1, which: (1) extended the effective date of the proposed amendments to FINRA Rules 0180, 4120 and 9610 to February 6, 2022; (2) extended the effective date of the proposed amendments to FINRA Rules 4210, 4220 and 4240 to April 6, 2022; and (3) conformed the proposed definition of "Legacy Swap" in proposed FINRA Rule 4240(d)(12) to reflect the new effective date of April 6, 2022. See FINRA Letter at 14-15.

The proposed effective dates will also align with the new expiration dates of current FINRA Rules 0180 and 4240, such that the temporary rules will expire on the day the proposed permanent rules become effective.<sup>212</sup>

### III. Discussion and Commission Findings

After careful review of the proposed rule change, as modified by Amendment No. 1, the comment letters, and FINRA's responses to the comments, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association.<sup>213</sup> Specifically, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the Exchange Act,<sup>214</sup> which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

#### **A. Proposed Rule 0180(a) (Application of FINRA Rules to Security-Based Swaps)**

As discussed above in Section II.B., the proposed rule change would replace current FINRA Rule 0180 with new FINRA Rule 0180 and would apply all FINRA rules to SBS activities and positions with respect to SBS, unless subject to specific exceptions set forth in proposed FINRA Rule 0180. Five commenters were supportive of the proposed rule change

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<sup>212</sup> As discussed above in Section II.A, in September 2021, the existing exceptions for current FINRA Rules 0180 and 4240 were extended to February 6, 2022 and April 6, 2022, respectively, and current Rule 4240 was amended to add Supplementary Material .02, which clarifies that the rule does not apply to a member that is registered with the Commission as an SBS. See Extension Notice, supra note 17.

<sup>213</sup> In approving this rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>214</sup> 15 U.S.C. 78o-3(b)(6).

generally.<sup>215</sup> One commenter suggested that, as an alternative, FINRA members be permitted to comply with the Commission’s SBS rules in lieu of a parallel FINRA rule.<sup>216</sup> The commenter proposed that FINRA could either consider incorporating into the FINRA rules a reference to the analogous Commission rules or permit FINRA-regulated broker-dealers not registered with the Commission as an SBSD to “opt-in” to the relevant Commission SBS rules.<sup>217</sup>

In its response, FINRA stated that neither of these alternatives would be appropriate.<sup>218</sup> FINRA believes the limited exceptions in proposed Rules 0180(c) through (g) are appropriate only in the context of registered SBS Entities subject to the SEC’s full regulatory framework applicable to such registrants.<sup>219</sup> FINRA does not believe that it would be appropriate to permit members that are not SBS Entities registered with the Commission to “opt-in” to the parallel SEC rules, or to incorporate SEC rules by reference for FINRA members not registered with the Commission as SBS Entities.<sup>220</sup> FINRA stated that a FINRA member engaged in SBS activities below the de minimis threshold for registration with the Commission may nonetheless elect to register with the Commission on a voluntary basis, and thereby become subject to the Commission’s full regulatory framework for SBS.<sup>221</sup>

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<sup>215</sup> See Letters at 1 (stating the need for the proposed rule change “to be enacted, as is, for the protection and operation of free and fair markets.”); see also SIFMA Letter at 1 (stating support for many aspects of the proposed rule change).

<sup>216</sup> See PML Letter at 4.

<sup>217</sup> Id.

<sup>218</sup> See FINRA Letter at 3.

<sup>219</sup> Id.

<sup>220</sup> Id.

<sup>221</sup> Id. at 3-4.

FINRA's determination to generally apply FINRA rules to members' activities and positions with respect to SBS,<sup>222</sup> other than the specific enumerated exceptions discussed below, is reasonable. Specifically, FINRA reasonably determined that, because SBS are securities under the Exchange Act, FINRA's existing rule framework, which is designed to regulate the securities activity of its members, should apply absent a specific exception. FINRA's determination is consistent with the requirement in the Exchange Act that FINRA, as a registered securities association, have rules designed to, among other things, facilitate transactions in securities and enforce compliance with the Exchange Act by its members.<sup>223</sup> Applying these rules to FINRA members' SBS activities and positions with respect to SBS will help prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors and the public interest.

The general presumption under Rule 0180(a) that FINRA rules apply to members' SBS activities and positions, except where otherwise specified in the rule, would help ensure that FINRA members that are not also registered as an SBS Entity with the Commission will be subject to a comprehensive set of FINRA rules governing, among other things, conduct and communication by members, with respect to the members' SBS activities and positions. It is appropriate that, with the exception of proposed Rule 0180(b),<sup>224</sup> an exception to this general presumption will apply only where a FINRA member is registered with the Commission as an SBS Entity. This important limitation will provide appropriate regulatory oversight with respect to SBS activity—where the FINRA member is registered with the Commission as an SBS Entity, the comprehensive framework the Commission has adopted for regulation of SBS, including its

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<sup>222</sup> See Notice at 26086. FINRA believes this determination is consistent with both Congress's intent and FINRA's regulatory responsibility. Id.

<sup>223</sup> See Exchange Act Section 15A(b)(2); (6).

<sup>224</sup> As discussed below, the proposed exception in FINRA Rule 0180(b) is not conditioned on registration as an SBS Entity but rather the general inapplicability of those rule sets to SBS activity.

examination program, will apply. Conversely, where the FINRA member is not registered with the Commission as an SBS Entity, it is appropriate for the member to comply with a comprehensive set of FINRA rules as set forth in the proposed rule change and be primarily subject to FINRA's examination program. In the event a FINRA member that is not required to be registered with the Commission as an SBS Entity would prefer to instead comply with the Commission's SBS regulatory framework (and avail itself of the exceptions specified in proposed FINRA Rule 0180(b)-(g)), the member may voluntarily elect to register as an SBS Entity with the Commission and thus become subject to the full regulatory framework for registered SBS Entities, which includes Commission examination authority for compliance with such rules. Accordingly, for the foregoing reasons, the Commission finds the proposed rule change is consistent with the protection of investors and in the public interest.

**B. Proposed Rule 0180(b) (General Exceptions From Applicability to FINRA Rules)**

Proposed FINRA Rule 0180(b) would specify certain exceptions from the general presumption of applicability of FINRA rules to SBS. Specifically, FINRA Rule 0180(b) would except members' SBS activities and positions from the FINRA Rule 6000 Series (Quotation, Order, and Transaction Reporting Facilities); the FINRA Rule 7000 Series (Clearing, Transaction, and Order Data Requirements, and Facility Charges); and the FINRA Rule 11000 Series (Uniform Practice Code). All commenters expressed support for FINRA's proposed rule change to exempt members' SBS activities and positions from these rules.<sup>225</sup> One commenter stated that "providing exceptions for [FINRA Rules 6000 Series, 7000 Series, and 11000 Series] will promote clarity, considering that these rules are not designed to apply to SBS, and arguably

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<sup>225</sup> See SIFMA Letter at 3; PML Letter at 2; Letters at 1.



overlap with some of the [Commission's] SBS rules (such as reporting and public dissemination under Regulation SBSR).”<sup>226</sup>

As discussed above in Section II.C., FINRA believes that the 6000, 7000 and 11000 series rules are not designed to apply to SBS and are not particularly well-adapted to positions in or activities involving SBS.<sup>227</sup> FINRA believes that while some of these rules could potentially be interpreted as applying to SBS activities by their terms, doing so could create operational difficulties and/or create confusion and uncertainty in the SBS market.<sup>228</sup> FINRA believes the proposed rule change would provide legal certainty and clarity for its members by specifically excepting these rules from applying to members' activities and positions with respect to SBS.<sup>229</sup>

The FINRA Rule 6000 and 7000 Series include various rules relating to trading, quoting, clearing and reporting for different types of securities. Many of these rules do not appear to apply to SBS by their terms.<sup>230</sup> As discussed in Section II.C, the FINRA Rule 11000 Series sets forth the UPC, a series of rules, interpretations and explanations created to simplify and facilitate the day-to-day business of investment banking and securities between FINRA members, particularly with respect to operational and settlement issues.<sup>231</sup> Because the UPC generally applies to all OTC secondary market transactions in securities, it could be interpreted as applying to SBS transactions. However, because the UPC applies only to transactions between FINRA members, even if the UPC were to apply, it could be invoked only for those specific

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<sup>226</sup> See SIFMA Letter at 3.

<sup>227</sup> See Notice at 26088.

<sup>228</sup> See id.

<sup>229</sup> See id.

<sup>230</sup> See id.; see also FINRA Rules 6000 and 7000 series.

<sup>231</sup> See Notice at 26088.

transactions.<sup>232</sup> FINRA believes that applying the UPC rules to such a limited subset of SBS in the overall SBS market could create confusion and uncertainty.<sup>233</sup>

The Commission finds that the proposed rule change would avoid unnecessary and potentially duplicative regulation in this area by specifically providing exceptions for SBS from the FINRA Rule 6000, 7000, and 11000 series, and is designed to protect investors and the public interest. These rules were not designed to provide regulatory oversight of SBS activity, and even if certain of these rules were interpreted to apply to SBS activity, they would apply only to a subset of SBS activity, leading to the potential for regulatory inconsistency. Accordingly, the Commission finds that the exceptions for the Rule 6000, 7000, and 11000 series in Rule 0180(b) is designed to protect investors and the public interest.

**C. Proposed Rules 0180(c) and (d) (Exceptions for Registered SBS Entities and Associated Persons)**

Proposed Rules 0180(c) and (d), as discussed above in Section II.D., would provide that specified FINRA Rules shall not apply to members' activities and positions with respect to SBS, only where the following conditions are met: (1) the member is acting in its capacity as an SBS Entity or the associated person of the member is acting in his or her capacity as an associated person of an SBS Entity, as applicable; and (2) that such activities or positions relate to the business of the SBS Entity within the meaning of the Exchange Act Rule 15Fh-3(h)(1), the Commission's supervision rule for SBS Entities. The exceptions in Rule 0180(c) would apply to both SBSDs and MSBSPs or their associated persons, while the exceptions in Rule 0180(d) would apply only to SBSDs or their associated persons (and not MSBSPs or their associated persons), consistent with whether the Commission rule that FINRA believes is analogous with a corresponding FINRA rule is applicable to all SBS Entities or their associated persons, or only

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<sup>232</sup> See id.

<sup>233</sup> See supra note 23 and related text; see also Notice at 26088.

SBSDs (and not MSBSPs or their associated persons).<sup>234</sup> One commenter specifically addressed these exceptions, offering support for their inclusion in the proposed rule, subject to requests for clarifications as to some aspects of the proposed exceptions that are addressed below.<sup>235</sup>

#### 1. Proposed Rule 0180(c)

Proposed Rule 0180(c) would except five FINRA rules from applying to members' SBS activities and positions where the conditions described above are met: (1) Rule 2210(d) (Communications with the Public – Content Standards); (2) Rule 2232 (Customer Confirmations); (3) Rule 3110 (Supervision); (4) Rule 3120 (Supervisory Control System); and (5) Rule 3130 (Certification of Compliance and Supervisory Procedures). As discussed below, FINRA believes that each of these rules is similar to a particular Commission rule or set of rules applicable to SBS Entities.<sup>236</sup> FINRA further believes that these proposed exceptions are appropriate only to the extent that the Commission's parallel SBS Entity rules will apply to the SBS activity, and only where the SBS activity relates to the business of the SBS Entity within the meaning of the Commission's SBS Entity supervision rule.<sup>237</sup>

Rule 2210(d) (Communications with the Public – Content Standards). FINRA Rule 2210(d) governs the content standards of members' communications with the public and requires communications be based on principles of fair dealing and good faith. Under FINRA's proposed rule change, where Exchange Act Rule 15Fh-3(g) applies to SBS Entities—imposing communication standards on both registered SBS Entities that are modeled after several of the existing requirements in FINRA Rule 2210(d)—those FINRA requirements would not also

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<sup>234</sup> See Notice at 26089.

<sup>235</sup> See SIFMA Letter at 3 (stating the rules to be excepted under the proposal and noting that “[a]s FINRA observes, these rules would unnecessarily duplicate certain of the Commission's SBS rules if they applied to SBS Entities or their associated persons”).

<sup>236</sup> See Notice at 26089.

<sup>237</sup> Id.

apply. Exchange Act Rule 15Fh-3(g) requires SBS Entities to communicate with parties in a fair and balanced manner based on principles of fair dealing and good faith. As the Commission has previously noted, this standard is consistent with the similarly worded requirement in FINRA Rule 2210(d).<sup>238</sup> Three additional Exchange Act Rule provisions supplement the required content standards of SBS Entities.<sup>239</sup> Taken together, FINRA believes that these provisions are analogous to FINRA requirements contained in Rule 2210(d) that require, among other things, member communications be based on principles of fair dealing and good faith, be fair and balanced, and not omit any material facts or make false or exaggerated claims.<sup>240</sup>

Rule 2232 (Customer Confirmations). Proposed Rule 0180(c) would except members registered as SBS Entities from the application of FINRA Rule 2232 (Customer Confirmations) with respect to their SBS positions and activities when such activities or positions relate to their business as SBS Entities within the meaning of the SBS supervision rule.<sup>241</sup>

FINRA Rule 2232 (Customer Confirmations) generally requires members to provide customers with written confirmations in conformity with Exchange Act Rule 10b-10,<sup>242</sup> along with specified additional disclosures for certain types of securities. Exchange Act Rule 15Fi-2 requires SBS Entities to provide trade acknowledgments and to establish, maintain and enforce

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<sup>238</sup> See Exchange Act Release No. 64766 (Jun. 29, 2011) at 86-7, 76 FR 42396 at 42418 (Jul. 18, 2011) (Proposed Rule: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants).

<sup>239</sup> FINRA stated that the SEC's business conduct rules also include requirements for SBS Entities to make certain disclosures to their SBS counterparties, including disclosures of material risks and characteristics and material incentives or conflicts of interest; daily mark disclosures; and disclosures regarding clearing rights. See Notice at 26090; see also Exchange Act Rules 15Fh-3(b)-(d) (addressing requirements for disclosures of material risks and characteristics and material incentives or conflicts of interest; daily mark disclosures; and disclosures regarding clearing rights).

<sup>240</sup> See Notice at 26090; see also FINRA Rule 2210(d)(1)(A).

<sup>241</sup> See Notice at 26089-90.

<sup>242</sup> See Notice at 26090; see also 17 CFR 240.10b-10.

written policies and procedures reasonably designed to obtain prompt verification of the terms of such trade acknowledgments.<sup>243</sup> FINRA states that the SEC's trade acknowledgement and verification rule provides that an SBS Entity that is also a broker or dealer, is purchasing from or selling to any counterparty, and that complies with the relevant requirements of the trade acknowledgment and verification rule, is exempt from the requirements of Exchange Act Rule 10b-10 with respect to the SBS transaction.<sup>244</sup>

In the Trade Acknowledgment and Verification Release, the Commission stated that requiring an SBS Entity that is also a broker or a dealer to comply with both Rule 10b-10 and Rule 15Fi-2 could be duplicative and overly burdensome.<sup>245</sup> In seeking the requested exemption from Rule 2232, FINRA has stated that FINRA similarly believes that applying both the SEC's rules for SBS Entities and FINRA's parallel rules for its members to the same SBS activity would result in unnecessary regulatory duplication.<sup>246</sup>

One commenter requested clarification concerning customer confirmations.<sup>247</sup> The commenter stated that the Commission has adopted an exemption concerning a broker-dealer's requirement to give or send the disclosure required by Exchange Act Rule 10b-10(a) at or before completion of the transaction in connection with such broker-dealer or its associated persons arranging, negotiating or executing an SBS transaction on behalf of an affiliated SBSD, provided that the broker-dealer gives or sends the customer written notification containing such disclosures in accordance with the time and form requirements for an SBSD's trade

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<sup>243</sup> See Notice at 26090; see also 17 CFR 240.15Fi-2; see generally Trade Acknowledgment and Verification Release, supra note 13.

<sup>244</sup> See Notice at 26090; see also 17 CFR 240.15Fi-2(g); Trade Acknowledgment and Verification Release at 39824-25.

<sup>245</sup> Trade Acknowledgment and Verification Release at 39821.

<sup>246</sup> See Notice at 26106.

<sup>247</sup> See SIFMA Letter at 3.

acknowledgment under Exchange Act Rule 15Fi-2(b) and (c) and, as applicable, Rule 10b-10(c).<sup>248</sup> The commenter requested that FINRA clarify that, to the extent a member would be eligible for this exemption, but not the proposed FINRA Rule 0180(c) exception from FINRA Rule 2232 (Customer Confirmations), it can satisfy Rule 2232 by giving and sending a written notification to its customer in accordance with the timing reflected in the exemption provided by the Commission in Exchange Act Rule 3a71-3(d)(5).<sup>249</sup>

In response, FINRA stated that FINRA Rule 2232(a) requires that a member shall, at or before the completion of any transaction in a security effected for or with an account of a customer, give or send to such customer a confirmation in conformity with the requirements of Exchange Act Rule 10b-10.<sup>250</sup> FINRA further stated that since the Commission has provided an exemption permitting a broker-dealer to provide the disclosures required by Exchange Act Rule 10b-10(a) in accordance with the time and form requirements for an SBSB's trade acknowledgment, a member acting in conformity with the requirements of Exchange Act Rule 10b-10, including where the member is acting in accordance with an applicable SEC exemption, would satisfy the requirements of Rule 2232(a) (provided that the member complies with all other provisions of Rule 2232, as applicable).<sup>251</sup>

Rules 3110 (Supervision), 3120 (Supervisory Control System) and 3130 (Annual Certification of Compliance and Supervisory Processes). Proposed Rule 0180(c) would except

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<sup>248</sup> See 17 CFR 240.3a71-3(d)(5).

<sup>249</sup> See SIFMA Letter at 4; see also Exchange Act Release No. 90308 (Nov. 2, 2020), 85 FR 70667 (Nov. 5, 2020) (Order Granting Exemptions from Sections 8 and 15(a)(1) of the Securities Exchange Act of 1934 and Rules 3b-13(b)(2), 8c-1, 10b-10, 15a-1(c), 15a-1(d) and 15c2-1 Thereunder in Connection with the Revision of the Definition of "Security" to Encompass Security-Based Swaps and Determining the Expiration Date for a Temporary Exemption from Section 29(b) of the Securities Exchange Act of 1934 in Connection with Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants).

<sup>250</sup> See FINRA Letter at 4.

<sup>251</sup> Id.

FINRA members that are also registered SBS Entities from the application of FINRA Rules 3110 (Supervision), 3120 (Supervisory Control System) and 3130 (Annual Certification of Compliance and Supervisory Processes) with respect to their SBS positions and activities where the conditions described above are met. Taken together, these rules require, among other things, that FINRA members establish and maintain a supervisory system, designate a chief compliance officer, and submit annual certifications to FINRA related to the member's compliance policies and written supervisory procedures.<sup>252</sup>

FINRA believes that the Commission has adopted an analogous framework for supervision of SBS Entities that applies to all FINRA members that are also registered SBS Entities.<sup>253</sup> Exchange Act Rule 15h-3(h) requires, among other things, that an SBS Entity establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its associated persons; designate at least one person with authority to carry out supervisory responsibilities; and establish, maintain and enforce written policies and procedures addressing supervision of the SBS Entity's SBS business. Exchange Act Rule 15Fk-1 requires each SBS Entity to designate a chief compliance officer and submit annual compliance reports to the Commission.

## 2. Proposed Rule 0180(d)

Proposed Rule 0180(d) would except three additional FINRA rules from applying to members' SBS activities and positions where the conditions described above are met and the FINRA member is a registered SBSD (but not a MSBSP): (1) Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities); (2) Rule 2090 (Know Your Customer); and (3) Rule 2111 (Suitability). As discussed below, FINRA believes that each of these rules is similar to a particular Commission rule or set of rules specifically applicable to

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<sup>252</sup> See Notice at 26090.

<sup>253</sup> See *id.* at 26089.

SBSDs but not MSBSPs.<sup>254</sup> FINRA further believes that these proposed exceptions are appropriate only to the extent that the Commission’s parallel rules applicable to SBSs (but not MSBSPs) will apply to the SBS activity, and only where the SBS activity relates to the business of the SBS (but not an MSBSP) within the meaning of the Commission’s SBS Entity supervision rule.<sup>255</sup>

Rule 2030 (Engaging in Distribution and Solicitation Activities with Government Entities). FINRA Rule 2030 governs “pay-to-play” activities by member firms that engage in distribution or solicitation activities for compensation with government entities on behalf of investment advisers. In particular, FINRA Rule 2030(a) prohibits a member from engaging in distribution or solicitation activities for compensation with a government entity within two years after a contribution to an official of the government entity is made by the covered member or a covered associate (including a person who becomes a covered associate within two years after the contribution is made).<sup>256</sup> Similarly, Exchange Act Rule 15Fh-6 generally prohibits an SBS from engaging in SBS transactions with a municipal entity within two years after certain political contributions have been made to officials of the municipal entity.<sup>257</sup> Under FINRA’s proposed rule change, where Exchange Act Rule 15Fh-6 applies to SBS Entities, the SBS Entity would be excepted from FINRA Rule 2030.

Rule 2090 (Know Your Customer). FINRA Rule 2090 requires members to use due diligence to know the essential facts concerning every customer (including the customer's financial profile and investment objectives or policy). Under FINRA’s proposed rule change, where Exchange Act Rules 15Fh-3(a) and (e) applies to SBSs, the SBSs would be excepted

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<sup>254</sup> See Notice at 26089.

<sup>255</sup> Id.

<sup>256</sup> See FINRA Regulatory Notice 16-40 (October 2016).

<sup>257</sup> Business Conduct Standards Release at 29962.



from FINRA Rule 2090. Rule 15Fh-3(a) generally requires SBS Entities to verify the status of their SBS counterparties.<sup>258</sup> Rule 15Fh-3(e) requires an SBSD to establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the essential facts that are necessary for conducting business with each counterparty that is known to the SBSD. Rule 15Fh-3(e) is a modified version of the “know your customer” requirements, such as those in FINRA Rule 2090, to which broker-dealers are subject.<sup>259</sup> Under FINRA’s proposal, where SBSDs are subject to Rule 15Fh-3(a) and (e), the analogous FINRA requirements would not also apply.

Rule 2111 (Suitability). FINRA Rule 2111(a) requires members, when making a recommendation, to have a reasonable basis to believe that recommendation is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. FINRA Rule 2111(b) provides that a member fulfills this suitability obligation for an institutional account if the member has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently and the institutional customer exercises independent judgment in evaluating the recommendations. Where the institutional customer has delegated decision-making authority to an agent, such as an investment adviser, these suitability rule factors apply to the agent under FINRA’s rule. Exchange Act Rule 15h-3(f) creates a suitability obligation for SBSDs, including an institutional suitability alternative that is modeled after FINRA Rule 2111(b).<sup>260</sup> Under

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<sup>258</sup> See Notice at 26090. Although Rule 15Fh-3(a) is applicable to both SBSDs and MSBSPs, FINRA Rule 2090 applies to requires members to use reasonable diligence “in regard to the opening or maintenance of” an account. FINRA Rule 2090. As MSBSPs are by definition not SBSDs, MSBSPs do not have customer accounts; therefore, Rule 2090 is inapplicable as to MSBSPs even if they are FINRA members. See e.g., 17 CFR 240.3a67-1.

<sup>259</sup> See Business Conduct Proposal at 42414.

<sup>260</sup> Business Conduct Standards Release at 29967, n.68.

FINRA's proposed rule change, where Exchange Act Rule 15Fh-3(f) applies, the SBS Entity would be excepted from FINRA Rule 2111.<sup>261</sup>

As to each of the FINRA rules proposed to be excepted under Rule 0180(c) and Rule 0180(d), an analogous Commission rule already applies to a registered SBS Entity (under Rule 0180(c)) or SBS (under Rule 0180(d)). Without these proposed exceptions, a FINRA member that is also registered with the Commission as an SBS entity (under Rule 0180(c)) or as an SBS (under Rule 0180(d)) would be required to comply with both the Commission's comprehensive framework enacted under Title VII as well as FINRA rules with analogous requirements. The Commission concludes it is generally unnecessary for FINRA rules to apply in circumstances where the SBS activities, and the SBS entities (under Rule 0180(c)) or SBSs (under Rule 0180(d)), are already regulated directly by the Commission. The Commission further concludes it is reasonable that the exceptions in FINRA Rule 0180(d) do not apply to MSBSPs, because they are not subject to either the FINRA rule referenced in Rule 0180(d) and/or the analogous Commission rule. Therefore, FINRA's proposal to provide the limited exceptions in proposed FINRA Rule 0180(c) and 0180(d), is a reasonable, tailored approach that reduces potentially unnecessary and duplicative regulatory requirements.

**D. Proposed Rule 0180(e) (Exceptions in Connection with Arranging, Negotiating, and Executing Activity)**

As discussed above in Section II.E., Proposed Rule 0180(e) would provide that the following FINRA rules shall not apply to members' activities with respect to SBS, to the extent that the member or the associated person of the member, as applicable, is arranging, negotiating or executing SBS on behalf of a non-U.S. affiliate pursuant to, and in compliance with the conditions of, the exception from counting certain SBS under Exchange Act Rule 3a71-3(d)(1):

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<sup>261</sup> FINRA also noted that Exchange Act Rule 15Fh-5 applies special, enhanced requirements when SBS Entities act as counterparties to special entities. See Notice at 26091.

(1) FINRA Rule 2111 (Suitability); (2) FINRA Rule 2210(d) (Communications with the Public – Content Standards); and (3) FINRA Rule 2232 (Customer Confirmations). The availability of the exceptions under proposed FINRA Rule 0180(e) would require the member’s compliance with the conditions specified in Exchange Act Rule 3a71-3(d)(1)(ii)(B) as if the member were the counterparty to the SBS transactions.<sup>262</sup> Specifically, to satisfy the exception from counting certain SBS under Exchange Act Rule 3a71-3(d)(1), the member must comply with, among other things, Exchange Act Rule 15Fh-3(b) (disclosures of material risks and characteristics and material incentives or conflicts of interest), Exchange Act Rule 15Fh-3(f)(1) (recommendations and suitability), Exchange Act Rule 15Fh-3(g) (fair and balanced communications) and Exchange Act Rule 15Fi-2 (acknowledgement and verification of SBS transactions).<sup>263</sup> If a member fails to comply with these Commission rules, the member’s foreign affiliate would be required to count each applicable SBS transaction toward its de minimis registration threshold.<sup>264</sup> One commenter specifically addressed this exception, offering support for its inclusion in the proposed rule.<sup>265</sup>

The Commission believes that members whose foreign affiliates are seeking to rely on the exception from counting certain SBS transactions under Exchange Act Rule 3a71-3(d)(1), may have their own obligations to comply with FINRA’s rules governing suitability, customer communications, and customer confirmations, apart from any obligation to comply with analogous Commission rules noted above as a condition of Exchange Act Rule 3a71-3(d)(1).

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<sup>262</sup> As discussed above, all other FINRA rules would remain applicable to a member acting as the U.S. Registered Affiliate under Exchange Act Rule 3a71-3(d). See supra note 46.

<sup>263</sup> See Notice at 26092-93.

<sup>264</sup> Id. at 26093.

<sup>265</sup> See SIFMA Letter at 1 (stating, “[w]e support this exception, which appropriately avoids overlaps between FINRA’s suitability, communication standards, and confirmation requirements, on the one hand, and SEC Rules 15Fh-3(f)(1), 15Fh-3(g), and 15Fi-2, on the other hand, which the FINRA member would be required to satisfy when acting for its non-U.S. affiliate pursuant to SEC Rule 3a71-3(d)(1)(ii).”).

Without the exceptions in proposed FINRA Rule 0180(e), this could result in unnecessarily duplicative obligations. Where the member is in fact complying with the specified Commission rules, the proposed rule change is designed to help protect investors and the public interest by avoiding potential confusion surrounding whether FINRA rules apply in addition to analogous Commission rules to regulate the same conduct. It is appropriate to provide exceptions from these FINRA rules to provide clarity and avoid unnecessary regulatory duplication. Accordingly, the Commission finds that the proposed rule change is designed to protect investors and the public interest.

**E. Proposed Rule 0180(f) (Exceptions from Rules 2231, Customer Account Statements, and 4512, Customer Account Information)**

Proposed Rule 0180(f), as discussed above in Section II.F., would provide that FINRA Rules 2231 (Customer Account Statements) and 4512 (Customer Account Information) shall not apply to members' activities and positions with respect to SBS, to the extent that the member is acting in its capacity as an SBS Entity and the customer's account solely holds SBS and collateral posted as margin in connection with such SBS, provided that the member complies with the portfolio reconciliation requirements of Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account.<sup>266</sup>

A commenter requested that FINRA provide two clarifications with respect to proposed FINRA Rule 0180(f). First, the commenter stated that FINRA should clarify that a member may rely on the Rule 0180(f) exception in circumstances where the member's SBS account for the customer also includes non-securities positions, such as swaps.<sup>267</sup> Second, the commenter stated

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<sup>266</sup> As a practical matter, the Commission states that most, if not all, requirements pertaining to the amount of collateral posted will be a "material term" for purposes of Exchange Act Rule 15Fi-1(i), such that this information would be required to be reconciled pursuant to Exchange Act Rule 15Fi-3.

<sup>267</sup> See SIFMA Letter at 4.

that FINRA should clarify that a member may rely on the Rule 0180(f) exception when, in addition to a customer's SBS account, the member carries a non-SBS securities account for the customer and there is no portfolio margining or other commingling between the two accounts.<sup>268</sup> In response, FINRA stated that the Commission, jointly with the CFTC, has published a request for comment on the portfolio margining of uncleared swaps and uncleared SBS.<sup>269</sup> As such, FINRA believes it would be premature to provide further guidance in this area at this time, but will consider addressing remaining questions through interpretive guidance when appropriate.<sup>270</sup>

Another commenter expressed support for eliminating the exceptions set forth in FINRA's proposed Rule 0180(f), maintaining that there is potential for confusion and disparate treatment as it pertains to FINRA Rules 2231 (Customer Account Statements) and 4512 (Books and Records/Customer Account Information) relative to Exchange Act Rule 15Fi-3 (the Commission's portfolio reconciliation rule for SBS Entities).<sup>271</sup> While the commenter respected FINRA's attempt to reduce burdens for participants, the commenter believes that with increased SBS activity, the exemption could be burdensome to some SBS Entities, while providing relief to other SBS Entities.<sup>272</sup> The commenter further believes that differences between FINRA Rule 2231 and Exchange Act Rule 15Fi-3 are "stark."<sup>273</sup> The commenter strongly supports portfolio reconciliation as a vital component to reducing systemic risk and other issues associated with SBS. However, as a practical matter this commenter believes that the burden of providing

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<sup>268</sup> See id.

<sup>269</sup> See FINRA Letter at 5; see also Exchange Act Release No. 90246 (Oct. 22, 2020), 85 FR 70536 (Nov. 5, 2020) (Request for Comment: Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps).

<sup>270</sup> See FINRA Letter at 5.

<sup>271</sup> See PML Letter at 5.

<sup>272</sup> Id.

<sup>273</sup> See id. at 6.

account statements based on a pre-defined methodology serves an important purpose for risk control as well.<sup>274</sup> Further, the commenter stated that there is a high likelihood that an existing SBS Entity that solely holds SBS and related collateral also is an affiliate of larger organizations with sufficient infrastructure to comply with FINRA Rule 2231.<sup>275</sup>

FINRA responded that the exception in proposed Rule 0180(f) applies only where a member is acting in its capacity as a registered SBS Entity and a customer's account solely holds SBS and collateral posted as margin in connection with SBS, provided that the member complies with the portfolio reconciliation requirements of Exchange Act Rule 15Fi-3 with respect to such account and that such portfolio reconciliations include collateral posted as margin in connection with SBS in the account.<sup>276</sup> FINRA believes that the SEC's portfolio reconciliation requirements set forth in Exchange Act Rule 15Fi-3<sup>277</sup> and the customer account statement requirements under FINRA Rule 2231 serve similar purposes such that requiring delivery of customer account statements for SBS-only accounts that are also subject to portfolio reconciliation would be unnecessary duplication.<sup>278</sup> FINRA further believes that it does not anticipate that this exception would create confusion, as SBS customers of an SBS Entity would expect to engage in portfolio reconciliation for their SBS accounts in accordance with the Commission rules, rather than for

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<sup>274</sup> Id.

<sup>275</sup> Id.

<sup>276</sup> See FINRA Letter at 5.

<sup>277</sup> See supra note 56.

<sup>278</sup> Id. at 6.

such SBS to appear on the customer account statement they may receive because the firm is also a FINRA member broker-dealer.<sup>279</sup>

The Commission recognizes that there are differences with respect to the frequency and timing requirements under Exchange Act Rule 15Fi-3 and FINRA Rule 2231. For example, whereas Exchange Act Rule 15Fi-3 requires SBS Entities to reconcile their portfolios with other counterparties more frequently than FINRA Rule 2231 requires its members to deliver an account statement to its customers, in some limited circumstances the Commission's rule would require portfolio reconciliation to occur less frequently than the timing requirements of FINRA's account statement rule.<sup>280</sup> Nevertheless, the Commission finds that under the limited circumstances in which the exception from FINRA Rule 2231 in proposed FINRA Rule 0180(f) applies, Exchange Act Rule 15Fi-3 should sufficiently serve similar purposes to FINRA Rule 2231, as it relates to providing information about an SBS with a customer who is a counterparty to an SBS, such that requiring members that are SBS Entities to also provide customer account statements for accounts holding solely SBS and related collateral would be unnecessarily duplicative. Further, as the exception only applies to accounts holding solely SBS and related collateral, the portfolio reconciliation requirements of Rule 15Fi-3 should provide sufficient risk

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<sup>279</sup> Id. FINRA further explained that it believes that a member that is not an SBS Entity and thus not subject to the SEC's portfolio reconciliation requirements—as well as other Commission rules related to risk mitigation, such as portfolio compression and trading relationship documentation—should include any SBS on a customer's account statements, regardless of whether such SBS are in a separate account from other securities, because SBS are securities. See id.

<sup>280</sup> Specifically, FINRA Rule 2231 requires each member to provide its customer with an account statement that satisfies the requirements of the rule on at least a quarterly basis. By contrast, the timing requirements in Exchange Act Rule 15Fi-3 vary, depending on whether the applicable counterparty is also an SBS Entity and the size of the SBS portfolio. The only time that portfolio reconciliation would be required to occur less frequently than quarterly would when an SBS Entity is facing a counterparty that is not also an SBS Entity and the size of the SBS portfolio does not exceed 100 SBS at any time during the calendar year, in which case the SBS Entity would only be required to have policies and procedures reasonably designed to ensure reconciliation on an annual basis. See 17 CFR 240.15Fi-3(b)(3)(ii).

control. To the extent that a customer's account includes SBS along with other securities positions or activity, or related money balances, then the account statement under FINRA Rule 2231 should include SBS. Thus, it is appropriate and consistent with the protection of investors and the public interest to provide an exception from FINRA Rule 2231 under circumstances when the Commission's risk mitigation requirements for SBS Entities under Exchange Act Rule 15Fi-3 will apply to SBS Entities, subject to the conditions discussed above. The Commission also recognizes, however, that this is an evolving market and a new regulatory framework, and acknowledges FINRA's commitment to consider providing interpretive guidance as appropriate.<sup>281</sup>

Similarly, the Commission's requirements pertaining to written SBS trading relationship documentation pursuant to Exchange Act Rule 15Fi-5, and the books and records requirements for SBS Entities that are also registered broker-dealers Exchange Act Rule 17a-3 will also continue to apply. These rules sufficiently serve similar purposes to FINRA Rule 4512, such that also applying FINRA Rule 4512 to SBS-only accounts would be duplicative. Accordingly, these limited circumstances in Proposed Rule 0180(f) reduce unnecessary and duplicative regulation.

**F. Proposed Rule 0180(g) (Exception from FINRA Registration for Certain Associated Persons of Registered SBS Entities)**

The FINRA qualification and registration requirements are set forth in the FINRA Rule 1200 series.<sup>282</sup> Proposed Rule 0180(g), as discussed above in Section II.G., would provide that persons associated with a member whose functions are related solely and exclusively to SBS,

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<sup>281</sup> See e.g., Exchange Act Release No. 90246 (Oct. 22, 2020), 85 FR 70536 (Nov. 5, 2020) (Request for Comment: Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps).

<sup>282</sup> FINRA Rule 1210 requires that each person engaged in the securities business of a member register with FINRA unless an exemption applies. See FINRA Rule 1210.



and undertaken in such person's capacity as an associated person of an SBS Entity, are not required to be registered with FINRA.

One commenter generally supported the exception but requested clarification that an associated person relying on the exception set forth in FINRA's proposed Rule 0810(g) may, in addition to their SBS activities, also engage in non-securities activities on behalf of the member, such as soliciting or accepting swaps in the capacity as an associated person or a swap dealer, and that additional activity would not otherwise trigger FINRA registration or continuing education requirements and would not prevent reliance on the proposed exception.<sup>283</sup> Further, the commenter suggested that FINRA Rule 0180(g) should clarify that the person's "securities-related functions" must be related solely and exclusively to SBS undertaken in such person's capacity as an associated person of a registered SBS Entity.<sup>284</sup>

A second commenter questioned the exemptions provided in proposed Rule 0180(g) and whether there are likely many, or even any, individuals associated with a FINRA member who would trade in SBS exclusively without also engaging in transactions in the underlying equity.<sup>285</sup> To the extent there are such individuals, the commenter further questioned whether such individuals should be exempt from FINRA's qualifications and registration requirements.<sup>286</sup> The commenter also expressed the belief that the likelihood of such individuals to enter the SBS market has the potential to increase.<sup>287</sup> It is the commenter's belief that, although the qualification examinations and continuing education ("CE") requirements may not specifically address SBS, the examination and CE requirements do require an associated person to have

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<sup>283</sup> See SIFMA Letter at 5.

<sup>284</sup> Id.

<sup>285</sup> See PML Letter at 4.

<sup>286</sup> Id.

<sup>287</sup> Id.

familiarity with the characteristics of the underlying equity securities and regulatory framework, which the commenter considers important to have for anyone engaged in SBS activities.<sup>288</sup> The commenter further maintained that the exemptions provided in proposed Rule 0180(g) may potentially cause “confusion for both exempt persons and ‘dual-hatted’ personnel,” and that such persons could avoid regulations such as FINRA Rule 2111 (Suitability) to which other registered persons are subject.<sup>289</sup> The commenter also stated that it may be unclear if FINRA Rule 4530 (Reporting Requirements) would apply to a member if the potentially reportable conduct involved a person associated with a member whose functions are related solely and exclusively to SBS undertaken in the person’s capacity as an associated person of a registered SBS Entity.<sup>290</sup>

In response to the comments, FINRA stated that a member is responsible for monitoring the activities of each of its associated persons to determine whether such person is required to be registered with FINRA and, if so required, to ensure that each associated person is registered in the appropriate category or categories.<sup>291</sup> FINRA cited to FINRA Rule 1210 (Registration Requirements), which requires persons engaged in the investment banking or securities business of a member to be registered “in each category of registration appropriate to his or her functions and responsibilities as specified” in FINRA Rule 1220.<sup>292</sup> FINRA Rule 1210 further states that persons “shall not be qualified to function in any registered capacity other than that for which the

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<sup>288</sup> Id.

<sup>289</sup> Id. at 5. With respect to the applicable suitability standard specifically, the commenter stated that SBSDs are afforded different treatment under the proposed rule change, as the Commission’s suitability rules would apply, creating another disparity for a non-SBS Entities participating in SBS to manage competing regulations. Id. As explained further below, contrary to the commenter’s assertion, proposed Rule 0810(g) provides no exemption to FINRA Rule 2111 for an associated person (unless the FINRA member satisfied the conditions of the exception in proposed FINRA Rule 0180(d)).

<sup>290</sup> Id.

<sup>291</sup> FINRA Letter at 6.

<sup>292</sup> Id. at 6, n.9. FINRA Rule 1220 sets forth registration categories. See FINRA Rule 1220.

person is registered, unless otherwise stated in the rules.”<sup>293</sup> FINRA also stated that the exception in proposed FINRA Rule 0180(g) would only apply to associated persons in the limited circumstances set forth in Rule 0180(g), and does not otherwise affect FINRA members’ responsibilities regarding the registration of their associated persons.<sup>294</sup> Thus, according to FINRA, a member relying on the proposed exception with respect to one or more of its associated persons would still need to monitor the activities of all of its associated persons, including any associated persons relying on the exception, to determine whether any of the person’s activities require registration under FINRA rules.<sup>295</sup> Accordingly, with respect to the commenter’s request for clarification, FINRA stated that it was not necessary to change to the text of proposed FINRA Rule 0180(g).<sup>296</sup> In so concluding, FINRA stated that the exception is structured similarly to existing exceptions from registration for persons associated with a member whose functions are related solely and exclusively to certain other products—specifically, associated persons transacting solely and exclusively in municipal securities, commodities, and security futures.<sup>297</sup>

FINRA stated that although it understands that the number of associated persons that would be eligible for the exception is likely to be limited, it believes the proposed exception is nonetheless appropriate to avoid unnecessary regulatory burdens with respect to even this limited set of individuals.<sup>298</sup> FINRA further stated that, under Commission rules, associated persons of SBS Entities, while subject to statutory disqualification prohibitions (and related background

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<sup>293</sup> Id.; see also FINRA Rule 1210.

<sup>294</sup> FINRA Letter at 6.

<sup>295</sup> Id. at 6-7.

<sup>296</sup> Id. at 7.

<sup>297</sup> Id. at 7; see also FINRA Rule 1230.

<sup>298</sup> Id. at 7-8.

check requirements), are not independently subject to registration, licensing or continuing education (“CE”) requirements imposed or administered by the Commission.<sup>299</sup> FINRA believes that, at the current time, there would be limited benefit to requiring FINRA registration for the limited group of individuals that would qualify for the proposed exception.<sup>300</sup> FINRA stated that it will monitor developments and continue to consider whether requiring registration for an associated person whose functions are related solely and exclusively to SBS in such person’s capacity as an associated person of a registered SBS Entity would be appropriate.<sup>301</sup>

In response to the comments concerning the potential for persons to avoid regulation, FINRA further stated that even in instances where an associated person is exempt from registration under proposed Rule 0180(g), the associated person would remain subject to all FINRA rules applicable to associated persons with respect to their SBS activities, unless another specific exception applied.<sup>302</sup> For example, an associated person excepted under proposed Rule 0180(g) would remain subject to suitability obligations under FINRA Rule 2111 (as well as Exchange Act Rule 15Fh-3(f) and, as applicable Rule 15Fh-5) when recommending SBS, unless the member satisfied the conditions of the exception in proposed FINRA Rule 0180(d) with respect to such activity.<sup>303</sup> In such circumstances, the member and the associated person would be required to comply with the Commission’s business conduct obligations, which impose

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<sup>299</sup> Id. at 8.

<sup>300</sup> Id.

<sup>301</sup> Id. at 8, n.12.

<sup>302</sup> Id. at 8.

<sup>303</sup> Id. The Commission notes that Exchange Act Rules 15Fh-3(f) and 15Fh-5 contain requirements that extend beyond the requirements found in FINRA Rule 2111—for example, an explicit requirement that an SBSD have a reasonable basis to believe the counterparty have an ability to absorb potential losses associated with the recommendation.

analogous requirements.<sup>304</sup> FINRA also stated that, notwithstanding the proposed rule change, a member and its associated persons would still be subject to FINRA Rule 4530 and related guidance with respect to their SBS activities (regardless of whether a particular individual relies on the exception from registration under proposed Rule 0180(g)).<sup>305</sup>

The Commission finds that the proposed registration exception is reasonable. The exception is limited in scope and applies only to persons associated with a FINRA member that is also a Commission-registered SBS Entity, where the associated person's functions are related solely and exclusively to SBS undertaken in such person's capacity as an associated person of the registered SBS Entity. Additionally, not only is the exception expected to apply to a limited number of persons, those individuals are still subject to other regulatory obligations. In particular: (1) persons qualifying for the Rule 0180(g) exceptions are still subject to all FINRA rules applicable to associated persons unless another specific exception applies; (2) all Commission rules applicable to associated persons of SBS Entities, including rules designed to prevent a statutorily disqualified person from associating with an SBS Entity, will apply;<sup>306</sup> and (3) FINRA members are obligated to monitor the activities of their associated persons and determine whether those activities give rise to an obligation to register the person under FINRA's rules. For the foregoing reasons, the Commission finds that the proposed exemption in Rule 0180(g) is designed to protect investors and the public interest. The Commission also recognizes, however, that this is an evolving market and a new regulatory framework, and

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<sup>304</sup> Id.

<sup>305</sup> Id. at 9.

<sup>306</sup> For example, Exchange Act Rule 15Fh-3(h)(2)(iii)(D) requires an SBS Entity to have procedures to conduct a reasonable investigation regarding, among other things, the qualifications and experience of any potential associated person.

acknowledges FINRA's commitment to monitor developments and to consider whether it would be appropriate to rescind the exception as the market develops further.<sup>307</sup>

**G. Proposed Rule 0180(i) (Authority to Grant Exemptions from the Application of Rule 0180 upon Member Application) and 9610 (Application for Exemptive Relief)**

Proposed FINRA Rule 0180(i), as discussed above in Section II.H., would provide FINRA with authority to consider exemptive relief from the application of specific FINRA rules to SBS on a rule-by-rule, member-by-member basis, other than the general presumption of applicability contained in proposed Rule 0180(a), which is not subject to exemption.<sup>308</sup> FINRA's proposed rule change would also make a conforming change to FINRA Rule 9610 to add FINRA Rule 0180 to the list of rules pursuant to which FINRA has exemptive authority.<sup>309</sup> A member's application for an exemption under proposed FINRA Rule 0180(i) would be subject to FINRA's existing procedures for all exemptive applications set forth in its Rule 9600 Series and described in more detail in Section II.G.<sup>310</sup> Pursuant to its procedures in FINRA Rule 9620, FINRA would be required to issue a written decision setting forth its findings and conclusions in response to the request for an exemption, which may be made publicly available.<sup>311</sup>

FINRA states that it needs the exemptive authority to respond to the evolving SBS market and to particular circumstances that may arise in which applying specific FINRA rules to

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<sup>307</sup> See FINRA Letter at 9, n.11-12; see also Notice at 26092.

<sup>308</sup> See Notice at 26093.

<sup>309</sup> Id.

<sup>310</sup> Id.

<sup>311</sup> Id. A FINRA member seeking a non-public exemption under Rule 9600 must include in its application a detailed statement, including supporting facts, showing good cause for treating the application or decision as confidential in whole or in part. See FINRA Rule 9610(b).

SBS activities or positions, not otherwise excepted by the proposed rule change, may not be appropriate or feasible.<sup>312</sup>

Proposed Rule 0180(i) would allow FINRA to exempt a person unconditionally or on specified terms from the application of individual FINRA rules beyond what is already proposed to be permitted under proposed Rule 0180.<sup>313</sup> Notably, the proposed rule change would not permit any exemption from proposed Rule 0180(a), which would provide that FINRA Rules shall apply to members' activities and positions unless specifically excepted elsewhere in the rule.<sup>314</sup> Thus, as proposed, FINRA could not use its authority under FINRA Rule 0180(i) to grant an exemption from the general application of FINRA rules to SBS activities.<sup>315</sup> Rather, FINRA would only be permitted to grant exemptions only on a rule-by-rule, member-by-member basis, consistent with the existing framework for granting exemptions for other FINRA rules as provided by Rule 9610.<sup>316</sup> Furthermore, any exemption must consider "all relevant factors," and FINRA may grant exemptions only if FINRA deems the exemption consistent with the protection of investors and the public interest.<sup>317</sup>

One commenter supported this proposed exemptive authority, noting that the exceptions described in the proposed rule change are tailored to the existing SBS market, and that this market may evolve in a manner that would justify further exceptions to FINRA rules.<sup>318</sup> As an example, the commenter noted that FINRA rules applicable to quoting and trading "may become more relevant to SBS in the future if trading or execution of SBS on exchanges or SBS execution

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<sup>312</sup> See Notice at 26093.

<sup>313</sup> Id.

<sup>314</sup> Id.

<sup>315</sup> Id.

<sup>316</sup> Id.

<sup>317</sup> Id.

<sup>318</sup> See SIFMA Letter at 6.

facilities becomes prevalent,” and that it may then be appropriate for FINRA to adopt additional exemptions “or otherwise clarify or tailor the application of those rules to SBS.”<sup>319</sup>

The Commission finds that the proposed exemptive authority under Rule 0180(i) is designed to protect investors and the public interest. The rule change will allow FINRA members to avail themselves of an existing procedural vehicle—FINRA’s Rule 9600 Series—to apply for exemptive relief from specific FINRA rules, on a case-by-case basis, to address unanticipated factual circumstances as market participants navigate the newly-regulated SBS market. As stated above, the Commission agrees with FINRA that, in light of Title VII’s amendment of the Exchange Act to specifically encompass SBS as securities, FINRA rules should generally apply to SBS in the same manner that such rules apply to securities generally, subject to the exceptions set forth elsewhere in proposed FINRA Rule 0180.<sup>320</sup> However, the Commission also recognizes the evolving nature of the SBS market, and that unanticipated factual circumstances may give rise to a need for FINRA to consider member applications for additional exceptions to specific FINRA rules on a case-by-case basis. The Commission expects that FINRA will, as it previously stated, apply heightened scrutiny to such applications for exemptive relief from its members not otherwise registered as SBS Entities with the Commission.<sup>321</sup>

To the extent that FINRA grants a number of exemptions pursuant to the process in its Rule 9600 Series for similar factual circumstances and/or identical FINRA rules, FINRA should consider filing a proposed rule change with the Commission to address those circumstances on a member-wide basis. Proposed Rule 0180(i) provides an appropriate vehicle that relies on an existing process for FINRA to consider providing limited exceptions on a member-by-member, case-by-case basis as warranted by specific facts, and only where FINRA deems appropriate

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<sup>319</sup> Id.

<sup>320</sup> See Notice at 26086.

<sup>321</sup> See Notice at 26093, n.66.



consistent with the protection of investors and the public interest. The proposed exemptive authority is reasonably designed to allow FINRA to consider unanticipated and novel factual scenarios that may warrant additional exceptions from its rules, but only where FINRA finds that such relief is in the public interest and would protect investors. Thus, the Commission finds that the proposed FINRA Rule 0180(i) is designed to protect investors and the public interest.

#### **H. Financial Responsibility and Operational Requirements**

As discussed above in Section II.I., FINRA Rule 4120 (Regulatory Notification and Business Curtailment) sets forth certain early warning notification and business curtailment requirements if a member's capital falls below certain thresholds. These thresholds are based on the minimum capital requirements applicable to a member broker-dealer under Exchange Act Rule 15c3-1. As discussed above in Section II.I., the proposed amendments to FINRA Rule 4120 would conform the rule to the new and increased minimum capital requirements for Non-ANC Firms that are also registered as SBSs and for ANC Firms, adopted in the Capital, Margin, and Segregation Release.

The proposed amendments to FINRA Rule 4120 will align FINRA's historical early warning notification and business curtailment thresholds with the Commission's amended capital requirements for Non-ANC Firms that are also registered as SBSs and for ANC Firms, adopted in the Capital, Margin, and Segregation Release. The modified early warning thresholds are appropriately calibrated to provide FINRA with sufficient early warning that a FINRA member's capital levels may be deteriorating. The modified business curtailment thresholds also are appropriately calibrated to provide FINRA with the ability to require a FINRA member to reduce its business activities when its capital levels have deteriorated to a level that may jeopardize its ability to comply with regulatory capital requirements.

In addition, as discussed above in Section II.I., proposed FINRA Rule 0180(h) would provide that, for purposes of the FINRA Rule 4000 Series, all requirements that apply to a member that clears or carries customer accounts must also apply to any member that acts as a

principal counterparty to an SBS, clears or carries an SBS, guarantees an SBS or otherwise has financial exposure to an SBS. Applying these higher standards when a member enters into SBS transactions, or otherwise has exposure to SBS is appropriate given that SBS are complex transactions that will require detailed recordkeeping, margining, legal agreements, collateral management, reconciliation and risk management.

## **I. Margin Requirements**

As discussed above in Section II.J., FINRA is proposing to adopt a new margin rule specifically applicable to SBS. Current FINRA Rule 4240 would be replaced by new FINRA Rule 4240 that would prescribe margin requirements for SBS, including CDS. However, proposed FINRA Rule 4240 would not apply to any FINRA member that is registered as an SBSB. FINRA members that are SBSBs are subject to the margin requirements of Exchange Act Rule 18a-3 discussed above in Section II.J. FINRA stated that by applying margin requirements in these circumstances, the proposed rule change would fill an important regulatory gap, protect FINRA members against counterparty credit risk, maintain a level playing field for members, and prevent regulatory arbitrage. As discussed above in Section II.J., the margin requirements under proposed FINRA Rule 4240 would be structurally aligned with the margin requirements that apply to SBSBs under Exchange Act Rule 18a-3, with certain modifications that FINRA believes are necessary because FINRA members that are not SBSBs will not be subject to the Commission's comprehensive regulatory framework for SBSBs.<sup>322</sup> Thus, subject to certain exceptions in the proposed rule discussed above in Section II.J., proposed FINRA Rule 4240 would require members that are not SBSBs to collect and deliver variation margin on a daily basis to cover the member's current exposure to or from each SBS counterparty, and also to collect (but not deliver) initial margin from each SBS counterparty. FINRA members that are not SBSBs would also be required to monitor the risk of any Uncleared SBS Account and

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See Notice at 26097.

maintain a comprehensive risk analysis methodology for assessing the potential risk to the member's capital. Finally, FINRA is also proposing to amend FINRA Rules 4210 and 4220 to take into account members' SBS activities.<sup>323</sup>

Applying the proposed margin requirements to FINRA members that are not registered as SBSDs will fill an important regulatory gap because it will prescribe margin requirements for uncleared SBS for FINRA members that are not SBSDs and not subject to Exchange Act Rule 18a-3. The margin requirements in the proposed rule change will protect FINRA members against counterparty credit risk with respect to transactions in uncleared SBS.<sup>324</sup> In particular, the proposed margin requirements will address the risk of uncollateralized exposures in uncleared SBS for FINRA members that are not registered as SBSDs by prescribing variation and initial margin requirements, subject to certain exceptions, as well as requiring these firms to maintain a comprehensive written risk analysis methodology. In addition, adopting a stand-alone rule that applies margin requirements to uncleared SBS under proposed new FINRA Rule 4240 will reduce unnecessary and duplicative regulation for FINRA members regarding which FINRA margin requirements apply to uncleared SBS.

A commenter stated that proposed FINRA Rule 4240 would differ in several material respects from Exchange Act Rule 18a-3.<sup>325</sup> More specifically, the commenter stated that FINRA Rule 4240 would (1) not permit a member to use an approved model to calculate initial margin, (2) require a member to collect initial margin from affiliates that are not financial market intermediaries or majority owners, (3) not permit a member to apply an initial margin threshold, (4) not permit a member to apply a minimum transfer amount, and (5) not permit an ANC Firm to apply credit risk charges under paragraph (c) to Exchange Act Rule 15c3-1e in lieu of

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<sup>323</sup> See supra note 147.

<sup>324</sup> See Notice at 26097.

<sup>325</sup> See SIFMA Letter at 7-11.

collecting margin, except for SBS with a majority owner, or a registered or foreign SBS Dealer affiliate.<sup>326</sup> The commenter stated that these differences would present material issues for members subject to proposed FINRA Rule 4240, particularly in connection with certain inter-affiliate SBS designed to promote centralized, group-wide risk management, as well as SBS entered into with unaffiliated financial market intermediaries for hedging purposes. The commenter provided examples where it believed that the differences between Exchange Act Rule 18a-3 and proposed FINRA Rule 4240 would present material issues, including: (1) when a foreign dealer affiliate of a U.S. broker-dealer hedges risks of SBS based on U.S. securities with their foreign customers via offsetting SBS with the U.S. broker-dealer, (2) when a broker-dealer forms an affiliated special purpose vehicle to issue a structured note that references a security, and (3) when a broker-dealer, in order to hedge the risk of its securities inventory, enters into one or more SBS with unaffiliated financial market intermediaries.<sup>327</sup>

The commenter recommended that FINRA permit a broker-dealer to comply with Exchange Act Rule 18a-3 rather than proposed FINRA Rule 4240 to address these issues.<sup>328</sup> However, the commenter also stated that it appreciates FINRA's concerns regarding a smaller broker-dealer entering into uncleared SBS with margin requirements that differ from the requirements that would apply under FINRA Rule 4210 to equivalent securities positions.<sup>329</sup> To address this consideration, the commenter proposed that, in order for a FINRA member to apply Exchange Act Rule 18a-3 in lieu of proposed FINRA Rule 4240, the member must satisfy the higher capital requirements applicable to an SBSD in Exchange Act Rule 15c3-1(a)(10) (or the higher capital requirements applicable to an ANC Firm in Exchange Act Rule 15c3-1(a)(7)).

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<sup>326</sup> Id.; see also supra note 197 (defining “Registered or Foreign SBS Dealer”).

<sup>327</sup> See SIFMA Letter at 8.

<sup>328</sup> Id.

<sup>329</sup> Id.

The commenter further proposed that for such a member to use a model to calculate initial margin, the Commission would need to approve the model for use by an affiliate of the member that is registered as an SBSD.<sup>330</sup> The commenter also stated that if FINRA does not adopt these recommendations, then it should further modify proposed FINRA Rule 4240 to align more closely with Exchange Act Rule 18a-3.<sup>331</sup> The commenter stated that FINRA previously declined to incorporate this suggested modification because broker-dealers subject to the proposed margin requirements for uncleared SBS would not be subject to the regulatory framework applicable to SBSDs, in particular higher capital requirements applicable to registered SBSDs.<sup>332</sup>

FINRA responded to the comments stating that FINRA acknowledges that proposed FINRA Rule 4240 would differ from Exchange Act Rule 18a-3 in some respects.<sup>333</sup> While such differences may in some cases result in increased costs for members that are not registered SBSDs when entering into uncleared SBS transactions with certain counterparties, FINRA responded that the requirements of proposed FINRA Rule 4240 as set forth in the Notice are important to protect the financial condition of its members, given that members subject to the rule would not be subject to the comprehensive regulatory framework applicable to SBSDs.<sup>334</sup> FINRA also stated that a member can “opt-in” to Exchange Act Rule 18a-3 by registering as an SBSD.<sup>335</sup> FINRA further stated that SBSD registration is an important precondition to margining pursuant to Exchange Act Rule 18a-3, because SBSD registration assures that the

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<sup>330</sup> Id.

<sup>331</sup> Id.

<sup>332</sup> Id.

<sup>333</sup> See FINRA Letter at 10.

<sup>334</sup> Id.

<sup>335</sup> Id.

entity is fully regulated as an SBSD, including the higher minimum capital requirements applicable to SBSDs.<sup>336</sup> Therefore, FINRA believes it would not be appropriate to incorporate Commission margin rules by reference or allow non-SBSD members to “opt-in” to the Commission margin rules as an alternative to FINRA margin rules.<sup>337</sup> Further, FINRA stated the specific requirements of proposed FINRA Rule 4240 are appropriately calibrated to provide parity with both FINRA Rule 4210 and Exchange Act Rule 18a-3, where possible, but also to provide greater protection to the financial condition of members not subject to the Commission’s comprehensive requirements for registered SBSDs.<sup>338</sup>

The Commission concludes that it would not be appropriate for a FINRA member that is not registered as an SBSD to “opt in” to compliance with Exchange Act Rule 18a-3 in lieu of complying with proposed FINRA Rule 4240, including in cases where a member would comply with higher capital requirements. While the proposed margin requirements differ from Exchange Act Rule 18a-3 in some respects, FINRA proposed the amendments in part to reduce regulatory arbitrage between existing margin requirements under FINRA Rule 4210 and the proposed requirements for uncleared SBS under FINRA Rule 4240. For example, the margin requirements in proposed FINRA Rule 4240 do not contain any thresholds that are prescribed in Exchange Act Rule 18a-3 (such as the \$50 million threshold below which initial margin need not be collected by an SBSD). Therefore, the proposed margin requirements should reduce the risk that a broker-dealer would be incentivized to restructure existing securities margin accounts as uncleared SBS, since existing FINRA Rule 4210 does not contain any margin thresholds for securities. In addition, while broker-dealers and SBSDs are subject to comprehensive financial responsibility requirements, FINRA member firms that are not SBSDs are not subject to the

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<sup>336</sup> Id.

<sup>337</sup> Id.

<sup>338</sup> Id.

Commission's specific regulatory framework for registered SBSDs under Title VII of the Dodd-Frank Act, and Exchange Act Rule 18a-3, in particular, only applies to SBSDs and MSBSPs.

For those same reasons, FINRA declined to adopt a number of specific modifications suggested by a commenter to align proposed Rule 4240 more closely with Exchange Act Rule 18a-3 in lieu of allowing members to comply with Exchange Act Rule 18a-3.<sup>339</sup> FINRA stated that the commenter made a number of similar recommendations in its comments responding to the Concept Proposal.<sup>340</sup> FINRA stated that it had responded previously to these recommendations, which included several modifications from the margin rule described in the Concept Proposal that were intended to address the comments and enhance competitive parity, while still providing appropriate protection for the financial condition of non-SBSD members entering into uncleared SBS.<sup>341</sup> FINRA further stated that, as a general matter, proposed FINRA Rule 4240 is not intended to level the playing field between SBSDs and non-SBSD members entering into SBS, such as de minimis dealers.<sup>342</sup> Rather, FINRA stated that the proposed rule is intended to adequately protect members from counterparty credit risk and prevent regulatory arbitrage, in particular by removing incentives for members to restructure their traditional extensions of credit (e.g., margin lending) subject to FINRA Rule 4210 as uncleared SBS.<sup>343</sup>

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<sup>339</sup> Id. Specifically, the commenter proposed that FINRA: (1) adopt an initial margin exception for all majority-owned affiliates; (2) permit an ANC Firm to calculate credit risk charges in accordance with Exchange Act Rule 15c3-1e(c) for exposures to all counterparty types; (3) permit use of SEC-approved initial margin models for non-equity SBS; (4) adopt a \$50 million initial margin threshold, applicable on a group-wide basis; (5) adopt a \$500,000 minimum transfer amount; (6) align FINRA Rule 4240's collateral haircuts with Exchange Act Rule 18a-3; and (7) extend the deadline for posting or collecting margin for counterparties in distant time zones. See SIFMA Letter at 9-11.

<sup>340</sup> See Notice at 26107-09; see also FINRA Letter at 10.

<sup>341</sup> FINRA Letter at 10.

<sup>342</sup> Id.

<sup>343</sup> Id. at 10-11.

Further, with respect to a commenter's request for FINRA to align proposed new FINRA Rule 4240's collateral haircuts with Exchange Act Rule 18a-3, FINRA stated that it does not believe permitting the use of the haircuts applicable to SBS collateral under Exchange Act Rule 18a-3 would be appropriate.<sup>344</sup> As FINRA previously stated, the proposed rule change is not intended to level the playing field between SBSDs and non-SBSD members entering into SBS, such as de minimis dealers, but rather to prevent regulatory arbitrage between members extending credit through SBS and members extending credit through traditional means.<sup>345</sup>

With respect to the request for FINRA to extend the deadline for posting or collecting margin for counterparties in distant time zones, FINRA stated that Exchange Act Rule 18a-3 requires that a member take an applicable capital charge on positions that do not meet the margin requirements generally within T+1, but extends that deadline to T+2 if the counterparty is located in another country and four time zones away.<sup>346</sup> While proposed FINRA Rule 4240 would similarly require a capital charge if required margin is not collected on T+1, FINRA stated that FINRA Rule 4240 would not require liquidation of the position until T+3. FINRA stated that this timing follows the portfolio margin requirements under FINRA Rule 4210, and stated it is appropriate to require a capital charge on T+1 because the location of the counterparty does not affect the counterparty credit risk to the member.<sup>347</sup> However, FINRA believes that, generally, the additional time before liquidation is required should be sufficient to accommodate counterparties in distant time zones.<sup>348</sup>

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<sup>344</sup> Id. at 11.

<sup>345</sup> Id.

<sup>346</sup> In this context, "T+1" and similar terms refer to the number of business days after the date on which the person was required to compute the margin requirement. Id.

<sup>347</sup> Id.

<sup>348</sup> Id.



The Commission concludes that it is appropriate for FINRA to decline to adopt commenters suggestions to modify proposed new FINRA Rule 4240 to more closely align with the requirements of Exchange Act Rule 18a-3, including the rule's collateral haircuts. Proposed FINRA Rule 4240 will promote consistent margin requirements, including haircut requirements, between FINRA members extending credit through traditional means under FINRA Rule 4240 and FINRA members extending credit through SBS under FINRA Rule 4240. The requirements under new FINRA Rule 4240 will protect FINRA members from counterparty credit risk and prevent regulatory arbitrage by reducing incentives for members to restructure their traditional extensions of credit (e.g., margin lending) subject to FINRA Rule 4210 as uncleared SBS. Further, the proposed time period (T+3) with respect to required liquidations above should provide FINRA members that are not SBSDs the flexibility to accommodate counterparties in additional time zones.

Another commenter raised concerns regarding the disparate treatment for SBSDs with respect to uncleared SBS. The commenter stated that proposed FINRA Rule 4240 and Exchange Act Rule 18a-3 impose different margin and collateral requirements, depending on whether an entity is designated as an SBSD or a FINRA broker-dealer.<sup>349</sup> This commenter raised concerns that this difference could hinder the ability of a FINRA broker-dealer to compete with SBSDs or other SBS market participants on a level playing field. In particular, the commenter raised concerns that counterparties would potentially choose to transact with an SBSD rather than a similarly capitalized FINRA broker-dealer, in order to avoid the need for the daily collection of initial margin and variation margin, which could lead to reduced firm participation impacting overall costs and liquidity.<sup>350</sup>

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<sup>349</sup> See PML Letter at 7.

<sup>350</sup> Id.

In response, as discussed above in Section II.J., while proposed FINRA Rule 4240 would diverge from Exchange Act Rule 18a-3 in some respects, FINRA believes that proposed FINRA Rule 4240 appropriately protects members from counterparty credit risk and prevents regulatory arbitrage between different methods of extending credit.<sup>351</sup> FINRA does not believe that the potential for increased market liquidity if more members functioned as de minimis dealers justifies replacing the specific margin requirements set forth in proposed FINRA Rule 4240.<sup>352</sup> Moreover, FINRA stated that a FINRA member seeking to establish parity with other SBSDs with respect to margin requirements may elect to register as an SBSD and become subject to the Commission's comprehensive SBSD regulatory framework. FINRA stated that the intent of proposed Rule 4240 is not to level the playing field between SBSDs and members engaged in de minimis SBS activity, but rather to prevent regulatory arbitrage as between members extending credit through SBS and members extending credit in the traditional fashion.<sup>353</sup>

The proposed rule change will serve to promote consistent and transparent margin requirements for the uncleared SBS market and traditional securities markets for FINRA members that are not SBSDs. Further, proposed Rule 4240 will require a FINRA member to collect initial margin, and collect or post variation margin, unless an exception applies.<sup>354</sup> In structuring the proposed rule, FINRA has reasonably balanced the goal of reducing firm exposure to counterparty credit risk stemming from unsecured credit exposures in uncleared SBS transactions, with the potential costs and competitive impacts that may result from the proposed rule change. For example, FINRA has proposed a number of exceptions to the proposed margin

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<sup>351</sup> See FINRA Letter at 11.

<sup>352</sup> Id. at 11-12.

<sup>353</sup> Id. at 12.

<sup>354</sup> See Notice at 26097.

requirements,<sup>355</sup> which may lessen the competitive impacts and costs of the proposed margin requirements.

A commenter further sought clarification regarding Non-Basic SBS, and more specifically uncleared TRS structures.<sup>356</sup> The commenter stated that the SBS market is dynamic and that market developments, such as its proposed alternative trading system platform, may make commonplace transactions that today are limited. The commenter also stated that a key blocker to growth of this activity is potential ambiguity around timing and the open-ended nature of the approval process for margin requirements for Non-Basic SBS.<sup>357</sup> Finally, this commenter stated that SBSDs would be placed at a significant advantage under the proposed margin framework, and supported a more clearly defined process for FINRA members that are not SBSDs to evaluate new products within existing or potentially expanded lines of business.<sup>358</sup>

In response, FINRA stated that under proposed FINRA Rule 4240(b)(2)(C), a member may apply to FINRA for the approval of an Initial Margin Requirement for a type of SBS other than Basic CDS and Basic SBS. FINRA further stated that the proposed rule change sets forth the requirements for any such application, and provides that no member shall become a party to an SBS other than a Basic CDS or Basic SBS unless FINRA has approved an Initial Margin Requirement for such member's use with respect to that type of SBS.<sup>359</sup> In addition, FINRA believes other types of SBS—including CDS and equity TRS with complex features—may not be easily accommodated under the frameworks applicable to Basic CDS and Basic SBS, and that the specific risks of such SBS may not be readily apparent or quantifiable to FINRA without

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<sup>355</sup> Id. at 26101.

<sup>356</sup> See PML Letter at 6.

<sup>357</sup> Id. at 7.

<sup>358</sup> Id.

<sup>359</sup> See FINRA Letter at 12.

additional information. Further, FINRA stated that SBS can be complex financial instruments that pose substantial risks to the financial condition of members, and margin serves as an important means of protecting member firms, and thereby their customers and investors, from such risks.<sup>360</sup> FINRA also believes that the application process under proposed FINRA Rule 4240(b)(2)(C) permits appropriate flexibility so that FINRA and its member firms may analyze all relevant risks that may be associated with a new type of SBS product. FINRA also stated that proposed FINRA Rule 4240 defers to registered clearing agencies with respect to the margin requirements for Cleared SBS. Therefore, FINRA believes that FINRA members that are not SBSDs may enter into Cleared SBS without seeking approval under Rule 4240(b)(2)(C); the application process would only be required before entering into new types of uncleared SBS.<sup>361</sup>

The proposed application process for margin requirements for SBS that are not Basic SBS or CDS provides specific detail with respect to the application's requirements, while providing FINRA with the flexibility to determine if a proposed margin requirement adequately addresses the risks for a particular type of SBS, including through the ability to request additional information. These requirements will protect FINRA member firms from the risks associated with uncleared SBS with complex features by ensuring FINRA member firms that are not SBSDs set prudent margin levels for these instruments.

In conclusion, the proposed changes to FINRA Rules 4210, 4420, and 4240 will help to ensure that the risks to FINRA members that are not SBSDs with respect to their uncleared SBS exposures are adequately addressed through the collection of margin. In addition, the proposed rule changes will enhance risk management practices at FINRA members that are not SBSDs and that participate in the SBS markets. They also will prevent unnecessary regulatory duplication

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<sup>360</sup> Id.

<sup>361</sup> Id.

by applying the proposed margin requirements in proposed FINRA Rule 4240 to FINRA members that are not SBSs, and will not be subject to the margin requirements of Rule 18a-3.

IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Exchange Act<sup>362</sup> that the proposed rule change (SR-FINRA-2021-008), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>363</sup>

**J. Matthew DeLesDernier,**

*Assistant Secretary.*

[FR Doc. 2022-00376 Filed: 1/11/2022 8:45 am; Publication Date: 1/12/2022]

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<sup>362</sup> 15 U.S.C. 78s(b)(2).

<sup>363</sup> 17 CFR 200.30-3(a)(12).